

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57312; File No. SR-NYSE-2004-70)

February 12, 2008

Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Amendments No. 2, 3, and 5 and Order Granting Accelerated Approval to a Proposed Rule Change, as Modified by Amendments No. 2, 3, and 5, to Amend Rule 104 to Require Specialists to Yield Proprietary Trades to Later-Arriving System Orders

I. Introduction

On December 13, 2004, the New York Stock Exchange LLC¹ (“NYSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)² and Rule 19b-4 thereunder,³ a proposed rule change to amend NYSE Rule 104 to require that in transactions between a specialist and a contra order that have been agreed to but not yet reported, the specialist must yield to any system orders that enter the specialist’s book and can take the specialist’s position in such transaction except if the specialist’s transaction meets a specified exception. On January 7, 2005, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as modified by Amendment No. 1, was published for public comment in the Federal

¹ Formerly known as the New York Stock Exchange, Inc.

² 15 U.S.C. 78s(b)(1).

³ 17 CFR 240.19b-4.

Register on January 28, 2005.⁴ The Exchange filed Amendments No. 2,⁵ 3,⁶ 4,⁷ and 5⁸ to the proposed rule change on August 11, 2005, October 14, 2005, September 15, 2006, and February 8, 2008, respectively. The Commission received five comment letters from a single commenter opposing the proposed rule change.⁹ On June 7, 2005 and November 18, 2005, the Exchange submitted responses to the comments.¹⁰ This order provides notice of filing of Amendments No. 2, 3, and 5 to the proposed rule change, and grants accelerated approval to the proposed rule change, as modified by Amendments No. 2, 3, and 5.

⁴ Securities Exchange Act Release No. 51048 (Jan. 18, 2005), 70 FR 4171 (“Notice”).

⁵ Amendment No. 2 superseded the original filing and Amendment No. 1 in their entirety and included (i) clarifying changes to the descriptions of the exceptions to the rule, (ii) the addition of system orders to the exception relating to non-regular way transactions, and (iii) the addition of convert and parity orders (“CAP orders”) to the exception relating to electing transactions.

⁶ In Amendment No. 3, the Exchange revised the purpose section of the filing to clarify the discussion of the exception relating to non-regular way transactions. Amendment No. 3 also makes certain technical changes to the proposed rule change.

⁷ Amendment No. 4 was withdrawn on February 8, 2008, by Amendment No. 5.

⁸ In Amendment No. 5, the Exchange: (i) withdraws Amendment No. 4; (ii) makes certain technical corrections to the proposed rule change; (iii) clarifies that NYSE Rule 123B(d) does not apply to transactions handled pursuant to proposed NYSE Rule 104.10(10); (iv) eliminates references to the election of stop orders by specialists, as this functionality is now automated; (v) eliminates references to the Intermarket Trading System, which has been decommissioned; (vi) amends Item 5 of Amendment No. 2 to clarify that the Exchange had received comments on the proposal; and (vii) corrects a typographical error in Amendment No. 3.

⁹ See letters from George Rutherford, Consultant (“Rutherford”), to the Commission, dated February 18, 2005 (“February 18th Rutherford Letter”), April 8, 2005, June 15, 2005 (“June 15th Rutherford Letter”), October 20, 2005 (“October 20th Rutherford Letter”), and November 27, 2005 (“November 27th Rutherford Letter”) (together, the “Rutherford Letters”).

¹⁰ See letters from Mary Yaeger, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated June 7, 2005 (“June 7th NYSE Letter”) and November 18, 2005 (“November 18th NYSE Letter”).

II. Description of the Proposed Rule Change

The Exchange proposes to amend NYSE Rule 104 Supplementary Material .10 to provide that when a specialist has completed but not yet reported a transaction as principal with an order in the book or in the crowd, the specialist must yield to any order received through SuperDOT[®] that could take the specialist's place in the unreported principal transaction. The Exchange proposes to amend NYSE Rule 104 Supplementary Material .10 to add new section (10) to require that, notwithstanding the ability of a specialist to trade as principal with either a system order or a broker in the crowd, if a marketable order arrives on the book before the reporting of the specialist's trade as principal is complete, the specialist must yield to such order. Where the specialist is required to yield, the customer whose order entered the book would be reported as the contra party for the trade instead of the specialist.

The proposed rule would provide the following six exceptions to this requirement.

1. Correction of a Bona Fide Specialist Error in a Previously Reported Transaction.

These are cases where a specialist has to issue corrected reports that include dealer participation via the Display Book[®] to correct a previously executed and reported transaction. Such corrections could involve the price, volume, or names involved on a transaction. If an executable system order is on the same side as the dealer participation necessary to correct the error, this would trigger the Display Book's[®] "P" indicator (preventing the specialist from participating as dealer ahead of executable system orders). In this situation, the specialist would be permitted to use the override feature, provided that the specialist places an "Error" notation in the Display Book's[®] free form comment field. The specialist would be required to adequately document the error on the firm's books and records.

2. Trading in Satisfaction of the Specialist's Obligation to Give Up a Trade to an Agency Order. These are cases where Exchange policy permits the specialist to give up a trade to an agency order after the initial trade has been reported and the specialist cannot substitute the agency customer's name, such as where a customer requests to participate on a trade previously executed by the specialist as principal on a non-regular way basis. When reporting such substituted trades, the specialist would have to participate as dealer in order to unwind his own participation in the initial transaction. If an executable system order is on the same side as the dealer participation necessary to effect the substitution, this would trigger the Display Book's[®] "P" indicator. In this situation, the specialist would be permitted to use the override feature to complete the substitute transaction. The specialist would be required to document the substitution trade in the Display Book's[®] free form comment field.

3. Report of Non-Regular-Way Principal to Customer Transaction. These are cases where a member firm represents a non-regular-way settlement order (e.g., cash basis, next day, and seller's option) and the specialist is willing to trade with that order at a price at which there are regular-way settlement customer orders on the same side on the Display Book[®] at the same or a better price.¹¹ The override feature may be used by the specialist to effect the non-regular way transactions, provided, however, that the specialist may be required to give up the trade to an agency order if the customer indicates its willingness to participate on the same terms as the specialist.

¹¹ Non-regular-way orders may be represented by a broker in the crowd or may be entered through the SuperDOT[®] system.

4. Principal Participation in CAP Order Electing Transaction.¹² These are cases where the specialist chooses to execute the elected portions of CAP orders at the same price as the electing sale.¹³ In these cases, the specialist bases the price on the total volume of the electing orders and the CAP orders, and then effects both the electing transaction and the CAP transaction contemporaneously and at the same price. NYSE Rule 123A.30 requires the specialist to report the transaction that elects the CAP orders independently from the transaction that fills the elected CAP orders. Orders may arrive on the Display Book[®] between the time the specialist reports the electing trade and the fill for the CAP transaction, which would trigger the “P” indicator. In connection with the transaction filling the CAP order, the specialist would be permitted to use the override feature. The specialist would be required to document the dealer participation by placing an applicable comment in the Display Book’s[®] free form comment field.

5. Principal Participation in Connection with CAP Order Executed as Part of the Opening of Trading.¹⁴ These are cases where the specialist participates as dealer in connection with CAP orders. In these situations, the CAP orders are included in the specialist’s calculation

¹² In Amendment No. 5, the Exchange omitted stop orders from exceptions 4 and 5 because stop order execution is now automated. See Securities Exchange Act Release No. 54820 (November 27, 2006), 71 FR 70824 (December 6, 2006) (SR-NYSE-2006-65). Since specialists no longer handle stop orders manually, the exception from the proposed rule is no longer necessary.

¹³ See NYSE Rule 123A.30. CAP orders are orders in which the specialist may convert all or part of an unelected portion of a percentage order, and may trade on parity with the elected or converted portions of the order, as long as the specialist is not holding orders at the same price that do not grant parity. Even though the specialist is not obligated to guarantee an execution to CAP orders at the same price as the electing sale, he may choose to do so. The Exchange stated that it inadvertently omitted references to CAP orders in exception 4, although they were specifically referred to in an analogous situation in exception 5. Accordingly, in Amendment No. 2, the Exchange added CAP orders to exception 4.

¹⁴ Regarding elimination of stop orders from exception 5, see supra note 12.

of the opening price, are elected by the opening trade, and are executed contemporaneously and consecutively with the opening transaction at the opening price, but are reported separately from the report of the opening transaction. Orders may arrive on the Display Book[®] between the time the specialist reports the opening trade and the fill for the converted portion of the CAP orders, which would trigger the “P” indicator. In connection with the transaction filling the converted portion of CAP orders, the specialist would be permitted to use the override feature. The specialist would be required to document the dealer participation by placing the required comment in the Display Book’s[®] free form comment field.

6. Closing Transactions to Offset Market-at-the-Close (“MOC”) and/or Limit-at-the-Close (“LOC”) Order Imbalances. These are cases where the specialist participates on the closing transaction to offset a MOC and/or LOC order imbalance. The situation may arise if unexecuted market orders entered just prior to the close are assigned to the paired-off portion of the closing trades. When the specialist reports dealer participation to offset an imbalance on the first print of the closing (as required by Exchange Rule 123C(3)(A)) and there are market orders on the same side assigned to the paired off portion, which is the second print of the close, the “P” indicator would be triggered. In this instance, the specialist would be permitted to use the override feature. The specialist would be required to document the dealer participation by indicating “MOC” in the Display Book’s[®] free form comment field.

III. Discussion

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission finds that the proposed rule change, as

amended, is consistent with Section 6(b)(5) of the Act¹⁵ which requires, among other things, an exchange to have rules that are designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.¹⁶

The Commission notes that the proposed rule change should help ensure that system orders entered into the Exchange's Display Book through an Exchange order delivery system such as SuperDOT[®] receive executions in the Exchange market to the greatest extent possible, and should help to minimize the risk of improper trading ahead of SuperDOT[®] orders by the specialist. The Commission also believes that the exceptions to the proposed rule are sufficiently limited and represent situations in which it would continue to be appropriate for the specialist to act as principal, notwithstanding the presence of a new customer order on the book.

In his comments, Rutherford states that the proposal "attempts to codify a truly bizarre notion" whereby "an order must participate in trade even though the order was not even in the marketplace when the trade took place"¹⁷ Rutherford states that the Exchange's technological limitations (whether reporting or surveillance) seem to have given rise to this rule.¹⁸

¹⁵ 15 U.S.C. 78f(b)(5).

¹⁶ In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁷ February 18th Rutherford Letter, supra note 9, at 1. See also June 15th Rutherford Letter, supra note 9, at 1; and October 20th Rutherford Letter, supra note 9, at 2.

¹⁸ February 18th Rutherford Letter, supra note 9, at 4. See also June 15th Rutherford Letter, supra note 9, at 2; October 20th Rutherford Letter, supra note 9, at 2; and November 27th Rutherford Letter, supra note 9, at 5.

Rutherford also states that the proposal conflicts with existing Exchange rules and that the Exchange fails to address such conflict. For example, Rutherford believes that the proposed rule change is inconsistent with Rule 76's crossing/price improvement procedure, in that it would assign a price to a subsequent SuperDOT[®] market order without giving it an opportunity to receive a better price.¹⁹ In addition, Rutherford also states "[t]he fact that the specialist may have followed the crossing procedure (or not, as in a floor broker trade) in a prior trade has no relevance whatsoever to a specialist's responsibility to expose the subsequently arriving [SuperDOT[®]] order to market interest existing at the time the order is received."²⁰

Furthermore, Rutherford states the Exchange's proposal would not allow for the possibility of price improvement and that a SuperDOT[®] order arriving after a specialist has consummated a trade could suffer economic harm. In addition, Rutherford states that under the proposal, a specialist could participate in a better-priced transaction that should have gone to a later-arriving SuperDOT[®] order if, as the specialist is in the process of substituting the subsequent SuperDOT[®] order for its own interest in a consummated but not yet reported transaction, the Exchange's autoquote publishes an improved price.²¹ Rutherford also contends that the Exchange has used the term "yield" incorrectly and should instead have used the phrase

¹⁹ February 18th Rutherford Letter, supra note 9, at 5. See also June 15th Rutherford Letter, supra note 9, at 5-7; and October 20th Rutherford Letter, supra note 9, at 1.

²⁰ June 15th Rutherford Letter, supra note 9, at 6. In addition, Rutherford states that scenario 1, which was provided by the Exchange to illustrate the operation of NYSE Rules 76 and 91, would require a specialist "to try to buy stock when all he or she wants to do is sell" and to "do so in a manner that 'penny jumps' a public limit order they are representing as agent." Id. at 9. The Exchange subsequently corrected scenario 1. See November 18th NYSE Letter, supra note 10, at 1-2. Rutherford states that the revised scenario 1 is "still deeply flawed." See November 27th Rutherford Letter, supra note 9, at 3.

²¹ February 18th Rutherford Letter, supra note 9, at 6. See also June 15th Rutherford Letter, supra note 9, at 10.

“substitution of principals,” arguing that the Exchange’s use of the term “yield” will create confusion because of its traditional use in the securities context (as in, for example, Section 11(a)(1)(G) under the Act²²).²³

The Exchange believes that Rutherford’s comments are misplaced and should be disregarded.²⁴ Specifically, the Exchange states that “Exchange Rules 76 and 91 require that before purchasing (selling) for his own account, a specialist must offer (bid for) the security at a price that is lower (higher), by the minimum variation, than the specialist’s bid (offer) for his own account” to ensure “there is no other buy (sell) interest in the market that is willing to trade at the better price.”²⁵ The Exchange believes that “this procedure ensures that the specialist’s bid (offer) is the best available price at the time that the dealer trade is orally consummated, [and that] any later-arriving DOT order(s) to which the specialist must yield under proposed Rule 104.10[(10)] would, by definition, also be receiving the best available price in the market at the moment that that order arrived on the book.”²⁶ The Commission believes that this is a reasonable interpretation of the Exchange’s rules.²⁷

²² 15 U.S.C. 78k(a)(1)(G) (regarding an exchange member “yield[ing] priority, parity, and precedence in execution” to non-member orders).

²³ February 18th Rutherford Letter, supra note 9, at 5. See also June 15th Rutherford Letter, supra note 9, at 2-5; and November 27th Rutherford Letter, supra note 9, at 5. In addition, the Rutherford Letters discuss a number of Exchange proposed rule changes, rules and other matters unrelated to this proposed rule change.

²⁴ See June 7th NYSE Letter, supra note 10.

²⁵ Id. at 2.

²⁶ Id.

²⁷ The Commission also notes that the Exchange amended Rule 123B to clarify that a specialist executing systems order in accordance with proposed Rule 104.10(10)(i) is not required to expose such orders to buying and selling interest in the trading crowd. See Amendment No. 5, supra note 8.

In addition, the Exchange states that the proposal does not permit specialists to trade at the expense of subsequent SuperDOT[®] orders.²⁸ Specifically, the Exchange states that Rutherford's example is based on a flawed assumption that the later-arriving sell order was entitled to trade with the even-later-arriving buy order and that the fact that a better price is subsequently received is irrelevant.²⁹ The Exchange acknowledges that under the proposal the specialist might be able to trade with even-later-arriving order at the improved price.³⁰ Although this may appear unfair to the later-arriving order, the Exchange notes that "it is not a foregone conclusion that the specialist will be the contra party to the even-later-arriving" order, and believes that Rutherford ignores the fact the "the specialist continues to bear the market risk of yielding to the later-arriving sell order."³¹ The Commission agrees with the Exchange that it is not a forgone conclusion that the specialist will be the contra party to the even-later-arriving order. The Commission notes that, while the specialist may at times receive the benefit of trading with the even later arriving order at an improved price, the specialist is subject to market risk and the even-later-arriving order could just as easily be at an inferior price.

Finally, the Exchange disagrees with Rutherford that it misused the term "yield" and his belief that use of term would be confusing and should be changed.³² The Commission acknowledges the commenter's view that the Exchange's use differs from its use in some other contexts; at the same time, the Commission believes that the use of the term "yield" is appropriately within the Exchange's discretion.

²⁸ See June 7th NYSE Letter, supra note 10, at 3-4.

²⁹ Id. at 4.

³⁰ Id.

³¹ Id.

³² Id. at 2.

Rutherford responded to the Exchange by reiterating his prior comments and added that the solution to the inability of the Exchange surveillance systems to “distinguish between proper versus improper specialist principal trading” is “enhanced surveillance, not bizarre, radical new law.”³³ Although Rutherford does not agree with the approach taken by the Exchange, the Commission believes that proposal constitutes an appropriate exercise of the Exchange’s business judgment.

Rutherford further states that the Exchange does not provide sufficient rationale for the proposed rule or the exceptions thereto.³⁴ He also states that the Exchange did not comply with the requirements of Form 19b-4 with respect to Amendment No. 2.³⁵ The Commission believes that the proposed rule change, as amended, is sufficient to comply with the requirements of Form 19b-4.

³³ June 15th Rutherford Letter, supra note 9, at 2. See also November 27th Rutherford Letter, supra note 9, at 1.

³⁴ See October 20th Rutherford Letter, supra note 9, at 2. See also November 27th Rutherford Letter, supra note 9, at 1.

³⁵ October 20th Rutherford Letter, supra note 9, at 1. Specifically, Rutherford noted that in Item 1(b) the NYSE stated it “does not believe the proposal will have any direct effect, or any significant indirect effect, on any other Exchange rule in effect at the time of this filing.” Rutherford states “[i]t is inconceivable that the NYSE can make this statement in good faith” and that the “NYSE is proposing a procedure that is absolutely at odds with Rule 76/91.” Id. As stated above, the Commission believes that the Exchange’s interpretation of Rules 76 and 91 is reasonable. Also, as noted below, the Exchange amended NYSE Rule 123B to clarify that when a specialist is executing a system order pursuant to proposed NYSE Rule 104.10(10), the specialist is not required to expose the order to buying and selling interest in the crowd. In addition, Rutherford contends that the NYSE should have referenced his comments in Item 5 of Amendment No. 2 (regarding whether the Exchange has solicited or received comments). Id.

IV. Accelerated Approval

The Commission finds good cause, pursuant to Section 19(b)(2) of the Act,³⁶ for accelerating approval of Amendments No. 2, 3, and 5 to the proposed rule change prior to the thirtieth day after publication in the Federal Register.³⁷

In Amendment No. 2, the Exchange made clarifying changes to the proposed rules that raise no new or novel issues. The Exchange also revised the exception relating to non-regular way principal transactions to specify that such non-regular-way orders are “principal to customer” orders to capture orders represented by a broker in the crowd or entered through the SuperDOT[®] system. Previously, the Exchange inadvertently omitted system orders from the description of orders covered by this exception. In Amendment No. 3, the Exchange modified the discussion of this exception to reflect the corresponding change in the rule text in Amendment No. 2.³⁸ The Commission finds that the addition of system orders to this exception presents no new or novel issues.

In Amendment No. 2, the Exchange also amended the exception relating to principal participation in electing transactions to add CAP orders to the exception. In the case of CAP orders, the specialist bases the price on the total volume of the electing orders and the CAP orders, and then effects both the electing transaction and the CAP transaction contemporaneously and at the same price. NYSE Rule 123A.30 (CAP orders) requires the specialist to report the

³⁶ 15 U.S.C. 78s(b)(2). Pursuant to Section 19s(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for so doing.

³⁷ In Amendment No. 5, the Exchange withdrew Amendment No. 4. See supra note 8.

³⁸ In addition, the Amendment No. 3 made technical changes to the proposed rule change. The Commission believes that Amendment No. 3 does not raise any new issues.

transaction that elects the CAP orders independently from the transaction that fills the elected CAP orders. As a result, orders may arrive on the Display Book[®] between the time the specialist reports the electing trade and the fill for the CAP transaction. Although adding CAP orders to the exception may expand the number of instances in which a specialist may trade notwithstanding a later-arriving system order, the Exchange believes that the addition of CAP orders to the exception does not raise new issues. The Commission agrees with the Exchange that the addition of CAP orders to the exception does not raise any new issues.

In Amendment No. 5, the Exchange amended NYSE Rule 123B to clarify that, when a specialist is executing a system order pursuant to proposed NYSE Rule 104.10(10), the specialist is not required to expose the order to buying and selling interest in the crowd. The Commission believes that this amendment helps to address inconsistencies between proposed Rule 104.10(10) and other Exchange rules. Amendment No. 5 also eliminates references to the election of stop orders by specialists, as this functionality is now automated, and eliminates references to the Intermarket Trading System, which has been decommissioned. In addition, Amendment No. 5 makes technical and clarifying changes.³⁹ The Commission believes that Amendment No. 5 presents no new or novel issues.

Accordingly, the Commission finds that good cause exists, consistent with Sections 6(b)(5) of the Act,⁴⁰ and Section 19(b) of the Act⁴¹ to approve the proposed rule change, as modified by Amendments No. 2, 3, and 5, on an accelerated basis.

³⁹ See, e.g., discussion in note 35, supra and accompanying text.

⁴⁰ 15 U.S.C. 78f(b)(5).

⁴¹ 15 U.S.C. 78s(b).

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 2, 3, and 5, including whether Amendments No. 2, 3, and 5 are consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NYSE-2004-70 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NYSE-2004-70. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission

does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NYSE-2004-70 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴² that the proposed rule change (SR-NYSE-2004-70), as modified by Amendments No. 2, 3, and 5, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁴³

Florence E. Harmon
Deputy Secretary

⁴² 15 U.S.C. 78s(b)(2).

⁴³ 17 CFR 200.30-3(a)(12).