

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52969; File No. SR-NYSE-2005-38)

December 16, 2005

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Rules 104 (“Dealings by Specialists”) and 123E (“Specialist Combination Review Policy”) to Change the Exchange’s Capital Requirements for Specialist Organizations.

Pursuant to Section 19(b)(1)¹ of the Securities Exchange Act of 1934 (the “Exchange Act”),² and Rule 19b-4 thereunder,³ notice is hereby given that on May 26, 2005, the New York Stock Exchange, Inc. (“NYSE” or the “Exchange”) filed with the Securities and Exchange Commission (“SEC” or the “Commission”) a proposed rule change. On November 22, 2005, NYSE amended the proposed rule change, replacing it in its entirety (“Amendment No. 1”). The amended proposed rule change is described in Items I, II, and III below, which have been substantially prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The New York Stock Exchange, Inc. (“NYSE” or the “Exchange”) hereby proposes amendments to Rules 104 (“Dealings by Specialists”) and 123E (“Specialist Combination Review Policy”) to change the capital requirement of specialist organizations. The text of the proposed rule change is set forth below. Proposed new language is underlined; brackets indicate deletions.

¹ 15 U.S.C. 78s(b)(1).

² 15 U.S.C 78a et seq.

³ 17 CFR 240.19b-4.

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Rule 104. Dealings by Specialists

(a) – (b) No Change

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Supplementary Material: -----

Functions of Specialists

.10 through .17 No Change

Capital Requirements of Specialists [(effective June 1, 1971.)]

.20 [Regular s]Specialist[s] Organizations – Minimum Capital Requirements.—

(1) A member registered as a regular specialist at an active post must be able to assume maintain a position of 150 trading units in each common stock in which he is registered.

(2) A member registered as a regular specialist at an active post must be able to assume a position of 30 trading units in each convertible preferred stock, of 1200 shares in each of the 100 share trading unit non-convertible preferred stocks and of 300 shares in each of the 10 share unit non-convertible preferred stocks in which he is registered.

(3) The position which a member registered as a regular specialist at an active post must be able to assume, for each stock in which he is registered that is not included in (1) or (2) above, shall be determined by the Exchange. Such determinations shall be based upon the structure and characteristics of the security and shall be the amount prescribed in (1) or (2) above for the type of stock with the most similar structure and characteristics.

(4) A member registered as a regular specialist at the inactive Post must have, at all times, net liquid assets of at least \$150,000.

(5) With respect to any Investment Company Unit (as defined in paragraph 703.16 of the Listed Company Manual) or a Trust Issued Receipt, a member registered as a regular specialist [at an active post] shall maintain net liquid assets equivalent to \$500,000 for each such security in which the specialist is registered.]

(1) A specialist organization that is only registered in Exchange Traded Funds shall maintain the greater of \$500,000 for each Exchange Traded Fund or \$1,000,000.

~~[(6) 2] [Notwithstanding .30 of this Rule, e] Each [member registered as a regular] specialist organization [at an active post] must [be able to] maintain net liquid assets which shall be the greater of \$1,000,000 or the requirements set forth in Rule 104.21, except for those specialist organizations that are only registered in Exchange Traded Funds, as set forth in 104.20(1) above. [establish that he can meet, with his own net liquid assets, a minimum capital requirement which shall be the greater of \$1,000,000 or 25% of the position requirements as set forth in Paragraphs (1), (2) and (3) above, except as determined by the Exchange in unusual circumstances.]~~

(3) The Division of Member Firm Regulation must be informed immediately by a specialist organization [, in each instance, of his inability] whenever it is unable to comply with the [provisions] requirements set forth in [the above Paragraphs] Rules 104.20 or .21, as applicable.

~~[(7) 4] [For those members registered as a regular specialist subject to the Net Capital Rule (SEA Rule 15c3-1), t] The term "net liquid assets" refers to excess net capital computed in accordance with Rule 15c3-1, promulgated under the Securities Exchange Act of 1934 (the "Exchange Act") and the provisions of Exchange Rule 325 ("Capital Requirements") with the following adjustments:~~

(i) Additions for haircuts and undue concentration charges taken pursuant to Section (c)(2)(vi)(M) of Rule 15c3-1 on specialty securities in dealer accounts;

[(ii) Additions for any other haircuts on long positions which are deposited or pledged as collateral for funds borrowed to finance dealer transactions or positions in specialist securities;]

[(i)ii) Deductions for floor brokerage and/or commissions receivable;

[(iv)iii) Deductions for clearing organization deposits; and

(iv) Deductions for any cash surrender value of life insurance policies allowable under [the Net Capital Rule] Rule 15c3-1, under the Exchange Act.

[(8) For members registered as a regular specialist not subject to the Net Capital Rule, "net liquid assets" is defined as the excess of cash, net credit balances at clearing broker(s), and readily marketable securities over all liabilities.]

(5) In the event that two or more specialist[s] organizations are associated with each other and deal for the same specialist account, the [above] capital requirements enumerated in Rules 104.20 and .21 shall apply to such specialist[s] organizations as one unit, rather than to each specialist organization individually. Any joint account must be approved by the Divisions of Market Surveillance and Member Firm Regulation.

.21 [Concentration Measure]Specialist Organizations – Additional Capital Requirements.—

[Notwithstanding the provisions of (1) through (5) in Rule 104.20 above, if a regular specialist entity's market share exceeds 5% of *any* of the following concentration measures:

(1) All listed common stock (current);

(2) The 250 most active listed common stocks (over the previous 12 months);

(3) The total share volume of stock trading on the Exchange (over the previous 12 months); or

(4) The total dollar value of stock trading on the Exchange (over the previous 12 months)

such entity shall maintain net liquid assets equivalent to the following applicable requirements:

(i) \$4 million for each specialist security contained in the DJIA;

(ii) \$2 million for each specialist security contained in the S&P 100, *not* contained in (i);

(iii) \$1 million for each specialist security contained in the S&P 500, *not* contained in (i) or (ii);

(iv) \$500 thousand for each specialist common stock, excluding bond funds, *not* contained in (i), (ii) or (iii);

(v) \$100 thousand for each specialist security *not* included in (i) through (iv), excluding warrants.

(vi) \$500,000 for each specialist security that is an Investment Company Unit (as defined in paragraph 703.16 of the Listed Company Manual) or a Trust Issued Receipt.]

(1) Each specialist organization subject to Rule 104.21 must maintain minimum net liquid assets equal to:

(i) \$1,000,000 for each one tenth of one percent (.1%) of Exchange transaction dollar volume in its registered securities, exclusive of Exchange Traded Funds, plus \$500,000 for each Exchange Traded Fund; and

(ii) A market risk add-on, which shall be calculated as follows:

(a) The specialist organization may use an Exchange-approved value-at-risk (VaR) model to calculate its market risk add-on. The VaR model must have a 99%, one-tailed confidence level with price changes equivalent to a ten business day movement in rates and prices. To calculate the market risk add-on, the specialist organization multiplies the VaR of specialist dealer and related positions by the appropriate multiplication factor, which is set at a minimum of three. The results of quarterly backtesting determine which of the multiplication factors contained in Table 1 of Rule 104.22 a specialist organization must use; or

(b) For those specialist organizations not utilizing VaR or whose models have not been approved by the NYSE, three times the average of the prior twenty business days' securities haircuts on its specialist dealer's positions computed pursuant to Rule 15c3-1(c)(2)(vi), exclusive of paragraph (N), under the Exchange Act.

(2) A specialist organization may apply to the Exchange for authorization to use a VaR model to calculate its market risk add-on, in lieu of calculating the average of the prior twenty business days' capital requirement for securities haircuts under Exchange Act Rule 15c3-1(c)(2)(vi), exclusive of paragraph (N). Once a specialist organization has been granted approval by the Exchange to use a VaR model, it shall continue to compute its net liquid asset market risk add-on using VaR, unless a change is approved upon application to the Exchange. To apply for authorization to use a VaR model pursuant to NYSE Rule 104.21(1)(ii)(a), a specialist must submit in writing the following information to Member Firm Regulation with its application:

(a) A description of the mathematical models to be used to compute its market risk add-on;

(b) A description of the requirements as set forth in Exchange Rule 104.22; and

(c) Any other material the Exchange may request.

(3) Notwithstanding the requirements of Rule 98(b)(vii) (Capital Requirements Met Separately), the specialist organization's net liquid assets needed to meet the requirements in Rules 104.20 and .21 must be dedicated exclusively to specialist dealer activities, and must not be used for any other purpose without the express written consent of the Exchange.

.22 [Combinations of Specialist Entities] Definitions and Model Approval Process.—

[A specialist entity resulting from the merger, consolidation, acquisition, or other combination of specialist assets:

(i) subject to the concentration measure requirements of Rule 104.21, shall maintain net liquid assets in accordance with those provisions, *or* equivalent to the aggregate net liquid assets of the specialist entities prior to their combination, whichever is greater;

(ii) *not* subject to the concentration measure requirements of Rule 104.21, shall maintain net liquid assets according to the provisions of Rule 104.20, *or* equivalent to the aggregate net liquid assets of the specialist entities prior to their combination, whichever is greater.]

(1) For purposes of this Rule 104, specialist organizations must define the term “Exchange transaction dollar volume” consistent with the most recent *Statistical Data*, calculated and provided by the NYSE on a monthly basis.

(2) For a specialist organization’s VaR model to be approved, it must meet the following minimum qualitative and quantitative requirements:

(a) Qualitative Requirements.

(i) The VaR model used to calculate the market risk add-on for a position, along with a system of internal risk management controls to assist the specialist organization in managing the risks associated with its business activities, must be integrated into the daily internal risk management system of the specialist organization;

(ii) The VaR model must be reviewed both periodically and annually by qualified independent member organization personnel or a qualified third party; and

(iii) For purposes of computing the market risk add-on, the specialist organization must determine the appropriate multiplication factor as follows:

(A) As soon as possible, but no later than three months after the specialist organization begins using the VaR model to calculate their market risk add-on, the specialist organization must conduct backtesting of the model by comparing its actual daily net trading profit or loss with the corresponding VaR measure generated by the VaR model, using a 99 percent, one-tailed confidence level with price changes equivalent to a one business day movement in rates and prices, for each of the past 250 business days, or other period as may be appropriate for the first year of its use;

(B) On the last business day of each quarter, the specialist organization must identify the number of backtesting exceptions of the VaR model, that is, the number of business days in the past 250 business days, or other period as may be appropriate for the first year of its use, for which the actual net trading loss, if any, exceeds the corresponding VaR measure; and

(C) The specialist organization must use the multiplication factor indicated in Table 1 below in determining its market risk add-on until it obtains the next quarter's backtesting results:

<u>Table 1. Multiplication factor based on the number of backtesting exceptions of the VaR model</u>	
<u>Number of exceptions</u>	<u>Multiplication factor</u>
<u>4 or fewer</u>	<u>3.00</u>
<u>5</u>	<u>3.40</u>
<u>6</u>	<u>3.50</u>
<u>7</u>	<u>3.65</u>
<u>8</u>	<u>3.75</u>
<u>9</u>	<u>3.85</u>
<u>10 or more</u>	<u>4.00</u>

(iv) For purposes of incorporating specific risk into a VaR model, a specialist organization must demonstrate that it has methodologies in place to capture liquidity, event, and default risk adequately for each position. Furthermore, the models used to calculate deductions for specific risk must:

- (A) Explain the historical price variation in the portfolio;
- (B) Capture concentration (magnitude and changes in composition);
- (C) Be robust to an adverse environment; and
- (D) Be validated through backtesting.

(b) Quantitative Requirements.

(i) For purposes of determining market risk add-on, the VaR model must use a 99 percent, one-tailed confidence level with price changes equivalent to a ten-business day movement in rates and prices;

(ii) The VaR model must use an effective historical observation period of at least one year. The specialist organization must consider the effects of market stress in its construction of the model. Historical data sets must be updated at least monthly and reassessed whenever market prices or volatilities change significantly; and

(iii) The VaR model must take into account and incorporate all significant, identifiable market risk factors applicable to positions in the accounts of the specialist organization, including:

(A) Risks arising from the non-linear price characteristics of derivatives and the sensitivity of the market value of those positions to changes in the volatility of the derivatives' underlying rates and prices;

(B) Empirical correlations with and across risk factors or, alternatively, risk factors sufficient to cover all the market risk inherent in the positions in the dealer accounts of the specialist organization; and

(C) Specific risk for individual positions.

.23 Maintaining a Fair and Orderly Market.—

Solely for the purpose of maintaining a fair and orderly market, the Exchange may, for a period not to exceed 5 business days, allow a specialist entity to continue to operate despite such specialist entity's non-compliance with the provisions of Rules 104.2[1] 0 [and] or 104.2[2] 1.

.24 Relief specialists.—

(1) The requirements with respect to a member registered as a full time relief specialist, i.e., one who may be called upon to act as a relief specialist for an entire business day, shall be, net liquid assets of \$150,000_ [or a joint account with the regular

specialist in the stock. Any joint account must be approved by Regulation & Surveillance.]

(2) There is no requirement with respect to a member registered as a part-time relief specialist, i.e., one who may be called upon to act as a relief specialist for less than the entire business day, usually for lunch periods, etc. Dealings effected by a part-time relief specialist while relieving the regular specialist must be made for the account of the regular specialist whom he is relieving.

[Specialists may meet the above requirements either with their own capital or by availing themselves of the financing privileges provided by §220.04(g) of Regulation T or §221.3(o) of Regulation U of the Board of Directors of the Federal Reserve System ¶8121, 8218 which are explained at .30, below.]

[.30 Financing of specialists.— Under §220.04(g) of Regulation T and §221.3(o) Regulation U of the Board of Directors of the Federal Reserve System ¶8121, 8218, a member may have his transactions as a specialist financed on a basis which is mutually satisfactory to the specialist and the creditor. He may finance such transactions by borrowing from a bank on terms which are mutually agreeable; he may have a member organization finance such transactions in a special account on a margin basis which is mutually satisfactory to the specialist and the carrying organization; or he may have a joint account with the carrying organization for the purpose of having his specialist transactions financed on a margin basis which is mutually satisfactory.]

[Each specialist who makes such an arrangement must inform The Market Surveillance Division of the name of the creditor and the terms of the arrangement. The Market Surveillance Division must be informed immediately by telephone of the

intention: (1) to terminate or change an existing financing arrangement (confirmed subsequently in writing); or (2) to issue a margin call. (This Rule does not in any manner alter a member's notification requirements to Regulation & Surveillance.) The specialist is required to submit to that Department on Form SPC (see .40 below) an initial report at such time as the arrangement becomes operative, and monthly reports thereafter.]

[.40 Reports on Form SPC.— Each specialist who arranges to have his specialist transactions carried by a member organization on a margin basis lower than that required by the Board of Directors of the Federal Reserve System for regular margin accounts, must file with The Market Surveillance Division a report of Form SPC, (1) as of the first date that such arrangement becomes operative, i.e., when the margin in the specialist's account first fails to meet the requirements of the Board of Directors of the Federal Reserve System for regular margin accounts, (2) as of the date previous to the first date that the arrangement becomes operative, and (3) monthly thereafter, as of the last ledger date of the month, including the month in which the arrangement first becomes operative.

Similar reports must be filed by each specialist who, for the purpose of financing his transactions as a specialist, arranges with a bank to have a loan value extended to him in an amount greater than that permitted for the financing of his non-specialist transactions.

General Instructions

The report of a joint account may be prepared and forwarded by any participant. Forms may be obtained from Market Surveillance Division. Reports should be filed with that Department as promptly as possible after the ledger date as of which the report is prepared.

Specific Instructions

For specific instruction see the reverse side of Form SPC.]

[.50 **Income records.**— Each specialist and specialist organization shall submit, for the confidential use of the Exchange, such information relating to his or its specialty business as may be requested by the Exchange.

Each specialist and specialist organization shall keep its records showing the data set forth below so that they will be readily available when the Exchange requests them for its confidential use for the purpose of surveillance and study of specialists' operations:

- (i) total "actual" commission income earned in all specialty stock;
- (ii) share volume executed as agent by specialty stock; and
- (iii) dealer profit and loss by specialty stock.

Dealer profit and loss data must reflect, by specialty stock, any gain or loss occurring within an investment account.]

* * *

Rule 123E. Specialist Combination Review Policy

(a) – (e) No Change

(f) [Proponents of a] A specialist unit combination subject to review by either the Quality of Markets Committee or the Market Performance Committee under this policy must [agree that] result in:

(i) [the] total [amount of] capital [which each unit had separately prior to the proposed combination shall not be reduced, regardless of whether it would exceed the combined unit's new capital requirement] of the combined unit meeting, at a minimum:

(a) the requirements of Rules 104.20 – 104.21, (b) be acceptable to the Exchange, and (c)

the combined unit's capital requirement may be temporarily revised at the discretion of the Exchange; and

(ii) all required specialist capital be accounted for separately from any other capital, and be used solely for the specialist business.

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II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

Exchange specialist organizations must maintain net liquid assets as required by NYSE Rule 104, and in addition, must satisfy the net capital requirements prescribed in Rule 15c3-1,⁴ promulgated under the Securities Exchange Act of 1934 (the "Exchange Act").⁵ NYSE Rule 325 requires members and member organizations to comply with Exchange Act Rule 15c3-1 and also requires notification to the Exchange whenever tentative net capital has declined below defined levels. In addition, Rule 325 gives the Exchange the authority, at any time, to prescribe greater net capital or net worth requirements than those explicitly prescribed by the rule, or to require more stringent

⁴ 17 CFR 240.15c3-1.

⁵ 15 U.S.C. 78a et seq.

treatment of items when computing net capital, net worth and, by implication, net liquid assets. Further, the NYSE can restrict the business activities of specialist organizations consistent with good business practices and its obligation to maintain a fair and orderly market. Such restrictions may include prohibitions against business expansion and business reduction requirements.

The Exchange proposes to amend Rules 104 and 123E to change the capital requirement of specialist organizations. The Exchange believes that if the proposed amendments are adopted, Rule 104 would more accurately address market risks and volatility. Further, the changes to Rule 123E would eliminate the “marriage penalty” capital requirement for specialist organization combinations.

(i) Difference Between Net Capital and Net Liquid Assets

According to the Exchange, “Net capital” is a regulatory measure of the prudent level of liquid assets required for a broker-dealer.

However, the Exchange contends that the term “net liquid assets” refers to liquidity in the form of cash and cash equivalents that is immediately available (or within twenty four hours) to a specialist organization for the continuing purchase and sale of securities in which a specialist is registered, in support of the specialist book, and market maintenance. The Exchange believes that net liquid assets are a shorter-term form of liquidity that is meant to be available to the specialist organization pursuant to its daily activities of maintaining a fair and orderly market on the Exchange.

The Exchange believes that specialist organizations’ unique liquidity needs dictate the general form of the net liquid asset requirement. Further, the Exchange believes that it is important for all specialist organizations and market participants to

know that specialists have sufficient liquidity to support the specialist book and market maintenance activities. Therefore, the Exchange contends that a specialist organization's net liquid asset requirement functions to ensure that the specialist continues to operate; whereas a broker-dealer's net capital requirement functions to ensure that, if the broker-dealer were liquidated, the broker-dealer's obligations to its customers and creditors would be satisfied.

(ii) Background

(a) Position-Based Capital Requirements (Rule 104.20)

Exchange Rule 104.20 ("Regular Specialists") sets position requirements a specialist organization must be able to assume in each stock that it is allocated. For each Investment Company Unit or Trust Issued Receipt for which a specialist organization is registered, it must maintain net liquid assets equivalent to \$500,000. The rule also sets a minimum capital requirement, which is the greater of \$1,000,000 or 25% of the current position requirements.

(b) Concentration Requirements (Rule 104.21)

Specialist organizations are also subject to NYSE Rule 104.21 ("Concentration Measure Requirements") if a specialist organization's market share exceeds 5% of certain "concentration measures."⁶

Further, a specialist organization must maintain the following net liquid assets:

- (i) \$4 million for each specialist security contained in the Dow Jones Industrial Average;
- (ii) \$2 million for each specialist security contained in the S&P 100, not contained in (i);

⁶ (1) All listed common stock; (2) The 250 most active listed common stocks (over the previous twelve months); (3) Total share volume of stock trading on the Exchange (over the previous twelve months); or (4) Total dollar value of stock trading on the Exchange (over the previous twelve months).

(iii) \$1 million for each specialist security contained in the S&P 500, not contained in (i) or (ii); (iv) \$500,000 for each specialist common stock, Investment Company Unit (including Exchange Traded Funds) or a Trust Issued Receipt, excluding bond funds, not contained in (i), (ii) or (iii); and (v) \$100,000 for each specialist security not included in (i) through (iv), excluding warrants.

(c) Combinations of Specialist Entities (Rule 104.22)

When two or more specialist organizations combine as the result of a merger, consolidation, acquisition or other combination of assets, NYSE Rule 104.22 (“Combinations of Specialists Entities”), commonly referred to as the “marriage penalty,” generally requires the maintenance of:

- (a) net liquid assets in accordance with Rule 104.21, or equivalent to the aggregate net liquid assets of the respective specialist entities prior to their combination, whichever is greater; or
- (b) for those combinations not subject to Rule 104.21, net liquid assets pursuant to Rule 104.20, or the equivalent of the aggregate net liquid assets of the respective specialist entities prior to their combination, whichever is greater.

(d) Specialist Combination Review Policy (Rule 123E(f)(i))

Exchange Rule 123E(f) currently requires proponents of a specialist unit combination to agree that: (i) the total amount of capital which each unit had separately prior to the proposed combination shall not be reduced regardless of whether it would exceed the combined unit’s new capital requirement; and (ii) all required specialist

capital be accounted for separately from any other capital and be used solely for the specialist business.

NYSE Rule 123E(f)(i) applies a “marriage penalty,” similar to that set forth in Exchange Rule 104.22, to a combination of specialist organizations by requiring a higher capital requirement of the combined unit, rather than allowing a possible reduction of capital, in line with the new combined specialist organization’s capital requirement. Rule 123E(f)(i) does not recognize the benefits derived from such combinations, nor does it compensate for excess capital that may have been in each specialist organization prior to the merger.

(iii) Issues/Concerns With the Current Capital Requirements

In mid December 1987 – soon after the 1987 major stock market correction – there were 55 specialist organizations on the Floor of the Exchange. By the year 2000, when Exchange Rule 104.22 was adopted, those specialist organizations had merged, consolidated, acquired or combined to reduce that number to 25. By April 2005, further consolidation had reduced the number of specialist organizations to seven.⁷

The Exchange believes that the position-based requirement methodology set forth in NYSE Rule 104.20 is no longer appropriate in a marketplace where there are seven specialist organizations with sizeable capital bases and sophisticated risk management systems. The Exchange contends that concentration requirements set forth currently in Exchange Rule 104.21 significantly increase specialist organizations’ capital

⁷ Because of the marriage penalty the capital requirements for the remaining seven specialist organizations represent the combined amount of capital requirements of the 25 specialist organizations that since 2000 were merged, consolidated, acquired or combined. The Exchange believes that the current capital requirement does not recognize the benefits derived from such consolidation.

requirements: However, there is no gradual increase in the requirement. Once a specialist organization's market share exceeds 5% of any of the concentration measures they immediately are subject to the rule. The Exchange believes that this creates an unintended disincentive for a specialist organization to increase its market share.

The marriage penalty imposed by Rules 104.22 and 123E(f)(i) effectively subjects specialist organizations that have merged to the combined net liquid asset requirements of the two entities, although the Exchange contends that the incremental risk assumed may not be commensurate with the amount of net liquid assets required to be maintained. The Exchange believes that the current net liquid assets requirement for such specialist organizations is based neither upon the amount of risk a specialist organization is taking, nor upon the dollar value or volatility of its portfolio.

(iv) Proposed Amendments

The Exchange is proposing that NYSE Rule 104.20 (to be re-titled "Specialist Organizations – Minimum Capital Requirements") be amended to adopt risk-based requirements in lieu of the outdated and irrelevant position requirements, with the exception of Exchange Traded Funds ("ETFs"). For ETFs, the Exchange is proposing to amend Rule 104.20 to clarify that specialist organizations that are registered solely in ETFs maintain the greater of \$500,000 for each ETF or \$1,000,000.

Proposed amendments to NYSE Rule 104.21 (to be re-titled "Specialist Organizations – Additional Capital Requirements") would require a specialist organization to meet, with its own net liquid assets, a minimum capital requirement equal to:

- (i) \$1,000,000 for each one tenth of one percent (.1%) of Exchange transaction dollar volume in its specialty securities, plus \$500,000 for each Exchange Traded Fund; and
- (ii) A market risk add-on, which is calculated as either:
 - (a) An Exchange-approved value-at-risk (VaR)⁸ model to calculate its requirement for market risk; or
 - (b) For those not utilizing VaR or whose models have not been approved by the NYSE, three times the average of the prior twenty business day's securities haircuts on its specialist dealer's positions.

The Exchange believes this proposal utilizes the more generally recognized and, effective risk measurement tools employed by financial services firms, and increasingly by the Commission with particular respect to larger organizations, such as Consolidated Supervised Entities (“CSE”),⁹ whose financial impact upon the market is significant.

The Exchange is proposing definitions and guidelines for the model approval process in proposed Rule 104.22 (to be re-titled “Definitions and Model Approval

⁸ The Exchange believes that value-at-risk is a generally accepted method of measuring risk for financial organizations and notes that it is primarily used to establish trading limits and to stress test models and limits. It uses standard statistical techniques to design trading strategies and to correlate past risks with future risks to set trading limits and thereby to minimize potential losses. Value-at-risk models assess market risk based on the probability distribution for a portfolio's market value.

⁹ See Exchange Act Rule 15c3-1(c)(15) which, as part of the SEC’s Consolidated Supervised Entity (“CSE”) rules, establishes a voluntary method of computing net capital for large broker-dealers that are part of a CSE. Eligibility to use the alternative/CSE method is conditioned upon a broker-dealer’s compliance with several requirements, including comprehensive internal risk management procedures that address the firm’s market, credit, liquidity and operations risk.

Process”). The model approval process is designed after the SEC’s rules for consolidated supervised entities and includes qualitative and quantitative requirements for a specialist organization’s VaR model. Some of these requirements include: (1) the VaR model must be integrated into the specialist organization’s internal risk management system; (2) the VaR model must be reviewed both periodically and annually; and (3) methodologies to capture liquidity, event and default risk adequately for each position.

Specialists’ internal risk management systems must generally be consistent with standards outlined in the Commission’s CSE rules, particularly SEA Rule 15c3-4. Once a specialist organization has been granted approval by the Exchange to use a VaR model, it may continue to compute its net liquid asset requirement using VaR, unless a change is approved upon application to the Exchange. The Exchange will, from time to time, revisit and examine approved net liquid asset models and may, for good cause and consistent with standards set forth in the Commission’s CSE rules, increase or decrease the market risk add-on requirement. The Exchange will provide prompt subsequent notice to the Commission of any such adjustments.

The Exchange is proposing to add a section requiring that a specialist organization's net liquid assets needed to meet the requirements in NYSE Rules 104.20 and .21 must be dedicated exclusively to specialist dealer activities, and must not be used for any other purpose without the express written consent of the Exchange. This is currently required under Rule 123(f)(ii) when specialist organizations combine, and the Exchange believes it should be expanded to all specialist organizations’ required net liquid assets.

The Exchange is proposing to eliminate the marriage penalty of NYSE Rule 104.22 in its entirety. With a net liquid assets requirement based upon a specialist organization's traded volume on the Floor of the Exchange combined with an add-on for market risk requirement, the Exchange believes that it is not appropriate or necessary to arbitrarily increase a specialist organization's requirement when it combines with another.

The Exchange is also proposing to eliminate the marriage penalty of NYSE Rule 123E(f)(i) by requiring the specialist organization to maintain net liquid assets in accordance with the specialist capital requirements of Exchange Rule 104.20 to .21, and granting the Exchange discretion to temporarily revise the combined unit's requirements.

The Exchange is also proposing to delete specialist organization financing sections 104.30 ("Financing of Specialists"), 104.40 ("Reports on Form SPC") and 104.50 ("Income Records"). The deletion of Rule 104.30 is proposed to reflect the current reality that net liquid asset requirements must be met from specialists' own books and records and not from an account carried by a third party. The deletion of Rule 104.30 would render Rule 104.40 irrelevant. The recordkeeping requirements of Rule 104.50 have been rendered irrelevant in light of NYSE Rule 440 ("Books and Records") which incorporates, by reference, Securities and Exchange Act Rules 17a-3 and 17a-4.

Finally, the filing includes several minor technical amendments to the rules for purposes of clarity and consistency.

(v) Discussion

The Exchange believes that current net liquid asset requirements impose excessively high capital requirements on specialists that are not based upon the amount of

risk a specialist takes or the volatility of its portfolio. As a result, the Exchange believes that the rules impose unjustified costs on existing specialists and discourage new entrants to the market. The Exchange contends that under this proposal, current rules based on classes of allocated securities and capital penalties for mergers among specialists would be replaced by rules that focus on market stress and volatility, and market share measured by total dollar volume traded. The Exchange further contends that the new rules may encourage new specialist organizations to begin operations on the Floor of the Exchange.

(a) Correlation Between Specialist Organization Inventory Positions and the Market

The Exchange contends that changes in specialist organizations' inventory positions are highly correlated to changes in price movements in the broader market. They base their conclusion on data, compiled from September 1998 through October 2004, that compares aggregate long and short specialist position data with market movements, as represented by the S&P 500.¹⁰ The Exchange found that, on average, specialist organizations bought \$75 million of securities for each 1% decline in prices and sold \$75 million in securities for each 1% increase in prices. The greatest price decline in one day over this six year period was 6.2% on the S&P 500, which occurred on April 14, 2000. Total specialist net liquid assets decreased \$16 million as a result of this market move.

¹⁰ The NYSE performed an analysis of specialist risk exposure in volatile trading scenarios over a period of years with its member specialist organizations, including simulations of how specialist capital levels would fare if faced with extremely volatile situations similar to the October 19, 1987 market correction, and other "worst case" consecutive day price declines.

(b) Worst-Case Market Risk Scenario for Specialist Organizations

Utilizing the historical worst-case scenario,¹¹ and assuming specialist organizations open the trading day with a \$100 million net long position and incur a non-stop 30% market decline, the Exchange determined that a cumulative loss of \$377 million would result (assuming specialist organizations' purchases of \$75 million for each 1% decline in the market). Consequently, the Exchange believes that if specialist organizations started with \$1.1 billion of net liquid assets, they should have sufficient capital and liquidity during normal markets and be able to withstand worst case market shocks without interruption to their businesses. The Exchange believes that the remaining net liquid assets of \$723 million provides buying power¹² of \$2.9 billion, which should provide adequate liquidity in a normal market.¹³

(c) Market Risk/Net Liquid Asset Requirements

Therefore, based on the above analysis, the Exchange believes that maintaining a minimum of approximately \$1.1 billion of net liquid assets across all specialist

¹¹ A prime example of a worst-case scenario is the consecutive day declines that occurred in October 1987 when the DJIA dropped 31% and the S&P lost 29%. On October 16, 1987, 55 NYSE specialist organizations had net liquid assets totaling \$808 million. These assets dropped by \$196 million to \$612 million at the close on October 19, 1987. Buying power decreased from \$2.3 billion to \$1.1 billion. One half of this buying power was concentrated in eight specialist organizations. Twenty-three specialist organizations had less than \$5 million of buying power and thirteen specialist organizations had no buying power. In comparison, the 1929 crash resulted in a four consecutive day decline in the DJIA of 16%.

¹² Buying power is the total market value of securities in which a specialist is registered that can be purchased and/or sold on margin by the specialist organization, without depositing additional funds into the specialist organization's dealer account carried by another broker-dealer.

¹³ In such a scenario, the Exchange would have the flexibility under Exchange Rules 325 and 326 to prescribe greater net capital or net worth requirements, and/or restricting a specialist organization's business activities.

organizations would provide a prudent level of capitalization for normal business operations with sufficient reserve in the event of severe shocks to the market. The Exchange intends to reassess this proposed requirement annually based upon market volatility as well as the dollar volume of total shares traded by all specialist organizations to determine its continuing adequacy.

The Exchange contends that this proposal also encompasses a methodology whereby a specialist organization's risk measurement system is considered in determining required capital standards. In order to use a VaR model to calculate the specialist organization's net liquid asset requirement, the specialist must incorporate the VaR methodology into its risk management practices. The Exchange will be required to evaluate those risk management practices at specialist organizations, including a review of each firm's infrastructure for monitoring and controlling market risk, before they will be allowed to utilize VaR model requirements.

As the proposal is based on dollar volumes traded and average inventory positions, as well as average haircuts, the Exchange believes it does not unduly penalize a specialist organization for taking on larger positions in adverse market conditions. The Exchange believes that utilizing value-at-risk modeling as a component of the net liquid asset requirement creates an incentive for specialist organizations to develop state of the art risk measurement systems, as well as hedge their positions, thereby limiting potential losses.

d. Financing of Specialists

Under current Rule 104.30, specialist organizations can finance their transactions pursuant to Regulations T and U of the Federal Reserve System. Pursuant to the section,

a specialist organization must notify the Market Surveillance Department of the name of the creditor and the terms of the arrangement. The Exchange proposes to delete the section in its entirety since it is no longer relevant as specialist organizations can currently arrange for credit under other existing Exchange rules.

e. Reports on Form SPC

Under current Rule 104.40, specialist organizations that finance their transactions on a margin basis lower than that required by the Federal Reserve for regular margin accounts, must file Form SPC with the Market Surveillance Department. Similar reports must be filed by specialist organizations that arrange for a bank to have a loan value extended to the non-specialist organization in an amount greater than that permitted for the financing of the non-specialist transactions. The Exchange proposes to delete the section in its entirety as it would no longer be applicable in the absence of Rule 104.30.

f. Income Records

Under current Rule 104.50, specialist organizations must keep and produce, at the request of the Exchange, information on commission income, share volume, and dealer profit and loss. The Exchange proposes to delete the section in its entirety as it is no longer applicable with the adoption of Rule 440 (Books and Records), which incorporates by reference Rules 17a-3 and 17a-4, under the Exchange Act.

2. Statutory Basis

The statutory basis for this proposed rule change is Section 6(b)(5)¹⁴ of the Exchange Act. The proposed amendments to Exchange Rules 104 and 123E are consistent with the requirements of Section 6(b)(5), which requires that the rules of the

¹⁴ 15 U.S.C. 78f(b)(5).

Exchange must be designed, among other things, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and national market system, and, in general, to protect investors and the public interest. The proposed amendments are consistent with the Section in that they encompass a methodology whereby risk management is considered in determining required capital standards – similar to recent Commission amendments to Exchange Act Rule 15c3-1 regarding the alternative method for computing net capital for broker-dealers that are part of a consolidated supervised entity.¹⁵

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange has neither solicited nor received written comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

(A) by order approve such proposed rule change; or

¹⁵ See Release No. 34-49830 (S7-21-03).

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is 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 e-mail to rule-comments@sec.gov. Please include File Number SR-NYSE-2005-38 on the subject line.

Paper Comments:

Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F. Street, NE, Washington, DC 20549-9303. All submissions should refer to File Number SR-NYSE-2005-38.

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. Copies of such filing also will be available for inspection and copying at the principal office of the NYSE. 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 submission should refer to File Number SR-NYSE-2005-38 and should be submitted on or before **[insert date 21 days from publication in the Federal Register]**.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Jonathan G. Katz
Secretary

¹⁶ 17 CFR 200.30-3(a)(12).