BEAR STEARNS

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September 28, 2004

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

**Re. Amendment No. 1 to File No. SR-NYSE-2004-05 Relating to Amendments to NYSE Direct Plus+; and, by association, File No. S7-10-04 – Regulation NMS**

Dear Mr. Katz:

Bear, Stearns & Co., Inc. welcomes the opportunity to provide the Securities and Exchange Commission ("SEC" or "Commission") with comments on the above referenced filing by the New York Stock Exchange (NYSE). Given that the NYSE filing is indirectly linked to the Commission's Regulation NMS proposal[1], we respectfully request that certain comments herein be considered in the context of that proposal and related SEC rulemaking.

Bear, Stearns & Co. Inc. is a leading investment banking and securities trading and brokerage firm. With approximately $40.0 billion in total capital, Bear Stearns serves governments, corporations, institutions and individuals worldwide. The company's business includes corporate finance and mergers and acquisitions, institutional equities and fixed income sales and trading, securities research, private client services, derivatives, foreign exchange and futures sales and trading, asset management and custody services. Bear Stearns is a large NYSE clearing member, operates a NYSE floor brokerage operation, and is a majority owner of Bear Wagner Specialists LLC.

We understand the competing pressures on the NYSE to make changes to its marketplace. In response to these pressures, the NYSE has submitted an ambitious proposal[2] ("the NYSE Proposal") to transform the NYSE and create a unique new hybrid market (the "Hybrid market"). The NYSE is in the process of taking a significant step to bring more automation to its marketplace and to offer customers different choices over the way their orders are executed. We understand the difficulties involved in trying to balance numerous interests in this process of market structure evolution and in balancing the need for greater automation with the desire to maintain the fundamental benefits of the auction market. However, as we have learned from other rules and proposals in the past (e.g., SOES[3], decimalization[4]), market changes often bring unforeseen and unintended consequences. The main purpose of this

[1] Securities Exchange Act Release No. 49325 (February 26, 2005) 69 FR 11126 (the "Proposing Release"); Securities Exchange Act Release No. 49749 (May 26, 2004) 69 FR 30142 (the "Supplemental Release").
[2] Amendment No. 1 to File No. SR-NYSE-2004-05 Relating to Amendments to NYSE Direct Plus+.
[3] Nasdaq's Small Order Execution System (or SOES) was a system developed in 1984 and made mandatory for NASDAQ National Market stocks in 1988 after the market crash of 1987. The system provided small investors with automatic execution of orders up to 1000 shares at the best available price.
[4] While decimalization helped to simplify pricing of US securities for investors and helped bring US markets in line with the rest of the world, it has had a series of deleterious effects (e.g., reducing market depth and making it easier for dealers to step ahead of displayed orders) and continues to be criticized and debated.

letter is to raise some questions and concerns related to the NYSE Proposal that we believe must be addressed before final Hybrid Market functionality and rules are determined.

Without a doubt, the NYSE Proposal is the single most significant rule filing the Exchange has made in decades, if not in its long and prosperous history. It will fundamentally alter the workings of the NYSE floor-based auction market and will significantly affect how investors access and provide liquidity. As the implications of this filing are far-reaching, we believe that the NYSE, and the industry as a whole, should proceed cautiously.

## Key Concerns

**More information is required.** At present, it is difficult to fully anticipate how trading will take place in the new Hybrid market given the lack of detail in critical areas. As several of the gaps in the NYSE Proposal are noted in other letters on record, we will not restate them here. In short, the NYSE needs to provide a clear, user-friendly description of their Hybrid market proposal, with examples and scenarios. Some of our specific questions and concerns are outlined in the section below. We believe that the answers to these and other questions should be submitted as part of an Amendment to the initial NYSE filing.

**An additional comment period is required.** The SEC should allow a full 90 day comment period after an Amendment to the NYSE Proposal is filed, questions are answered, detail is provided, and market participants have a clearer sense of how the Hybrid market will truly function.

**Supporting economic/quantitative research should be provided.** There are number of areas where research should be provided to support core elements of the Proposal.

- Much of the debate over the trade through rule has focused on the behavior of highly active securities, often focusing on Exchange Traded Funds like the Nasdaq-100 Index Tracking Stock (QQQ). In our view, trading patterns and price discovery processes for highly active securities, and, in particular, ETFs, are quite different from those of illiquid securities. While much data has been discussed regarding S&P 500 stocks, we have not seen ample analysis supporting the benefits of full auto-ex for illiquid stocks, e.g., comparisons of spreads, fill rates, and volatility for like NYSE and Nasdaq securities.
- We would like to see data and analysis that supports the determination of Liquidity Replenishment Points (LRPs). We would like to see short-term volatility data for stocks of varying liquidity to better understand the expected frequency of “slow markets” relative to LRPs as they are defined.

**The NYSE should implement the Hybrid market as a pilot program.** From the information available in the NYSE Proposal, we believe that the NYSE market is about to be fundamentally changed. These changes, once enacted, will not likely be reversible. We believe that these changes could result in increased market fragmentation and volatility, increased quote traffic with shorter display periods, a change in market composition,[5] less overall market stability, a further reduction in trade sizes, and a material change in the price discovery process.[6] We believe that fundamental changes of this magnitude should be implemented on a pilot basis, studied, and reviewed before becoming a permanent fixture in our nation’s equities markets.

[5] This, for example, should include greater participation by statistical arbitrageurs, program traders, day traders, and others seeking short-term trading profits from increased volatility, inefficiencies in intermarket linkages, and easier electronic access. This will also accelerate the widespread use of algorithmic trading in the listed world.

[6] Greater market fragmentation among competing markets utilizing hidden reserve orders should result in auction market price discovery as we know it being replaced by a new form of electronic price discovery.

**The NYSE should consider separate and distinct rules for illiquid securities.** While the proposed changes may turn out to work well for liquid securities, we are not convinced that the proposed level of automation is appropriate for all securities. More than 2,150 (approximately 60%) NYSE listed securities have an average daily trading volume of less than 100,000 shares (that "trade by appointment"). These securities are of particular concern. We believe that this category of securities should be exempt from 'full auto-ex' status and that the SEC should *not* include this category of stocks in any possible 'slow quote' trade through exception.[7] We believe that no compelling evidence has been provided to show that the potential benefits of full automation for these stocks (which may be accompanied by increased spreads and volatility) outweigh the benefits currently provided by a negotiated market.

**The NYSE should address new intermarket issues relating to trading halts and excessive market volatility.** At present, with approximately 80% of the volume in NYSE listed securities, NYSE non-regulatory trading halts are effective. In a more fragmented trading environment where other markets are permitted to trade through NYSE quotes when in "slow mode," we are concerned that egregious market momentum problems will result from aggressive trading behavior and/or from system or program malfunctions. The Nasdaq UTP Operating Committee, for example, recently amended its Operating Plan to deal with the need for intermarket trading halts resulting from "extraordinary market activity as a result of system misuse or malfunction".[8] We believe that, in the NYSE Hybrid environment, non-regulatory trading halts and market pauses from LRPs may be ineffective if (as we would expect) market access technologies are programmed to ignore NYSE quotes when they are "slow."

At Bear Stearns, we look forward to receiving and reviewing additional information in the near future to help us better understand and contribute to this critical development in our nation's capital markets. We appreciate both the NYSE's and the SEC's consideration of our questions and issues, and look forward to continuing a constructive dialogue on this Proposal.

Respectfully Submitted,

Bruce Lisman

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[7] Bear Stearns supports a uniform trade-through rule, which we believe will encourage the use of displayed limit orders. We also believe that definitions of an "automated order execution facility" should be applied to quotes rather than markets generally. However, we do not believe that an "automated market" should be permitted to execute orders within its market without regard to a better price displayed on a "non-automated market" for illiquid securities (defined as stocks that average less than 100,000 shares per day). Given that we support a Pilot period for the Hybrid proposal, we support *testing* a trade-through exemption for "non-automated quotes" for a limited set of illiquid securities during the Pilot period, but do not believe that there is compelling evidence at this time to make such an exemption permanent.

[8] This was largely driven by the now notorious trading problem in Corinthian Colleges (COCO) on December 5, 2003. We believe that the COCO-type problem, heretofore primarily experienced in the Nasdaq marketplace, will soon be a real risk for NYSE listed securities. See Amendment No. 13C to the Nasdaq/National Market System Unlisted Trading Privileges Plan Filed Pursuant to SEC Rules 11Aa3-2 and 11Aa3-1.

Cc: The Hon. William H. Donaldson, Chairman
The Hon. Paul S. Atkins, Commissioner
The Hon. Cynthia A. Glassman, Commissioner
The Hon. Harvey J. Goldschmid, Commissioner
The Hon. Roel C. Campos, Commissioner
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