February 1, 2006

Dear SEC:

(The substance of this letter is addressed to SR-NYSE-2005-74, but is also being submitted under SR-NYSE-2004-05, the context in which the underlying issues first arose)

I am writing with reference to the NYSE's latest attempt (January 31, 2006) to respond to criticisms of SR-NYSE-2005-74.

At the outset, let me say that the NYSE's intellectual dishonesty continues to astound. In all my years of reviewing U.S. SRO rule submissions, I have never encountered anything as truly bizarre as what is going on here. (I ask that all my prior correspondence on this matter be incorporated by reference herein).

If the NYSE were truly acting in good faith here, this should be a simple, straight-forward matter. The NYSE claims that it has a "longstanding interpretation" permitting specialist parity acquisiti on trading (i.e., trading in which the specialist competes directly with public orders). The NYSE ought to be able to produce documents dating back to the 1930s and 1940s (the time periods of other documents cited by the NYSE to no relevant effect whatsoever) in which this "longstanding interpretation" is clearly set forth. In addition, the NYSE ought to be able to demonstrate that this "longstanding interpretation" has been clearly communicated to, and approved by, the SEC, and has been clearly communicated to all relevant constituencies. The NYSE has, however, failed utterly in all such respects to produce any such documentation whatsoever. Rather, the NYSE staff appear to be rummaging wildly through old files and attempting to pass off clearly irrelevant material as some sort of "basis" for the "longstanding interpretation", notwithstanding the fact that the material unearthed by the NYSE staff does not refer to the "longstanding interpretation" in any way, shape, or form, o r to any effort by the NYSE to communicate such a matter. It is truly pitiful to see the NYSE staff embarrass themselves in this way.

This is not simply an arcane, technical issue. As a matter of substance, it is addressed to putting the interests of the public ahead of the interests of a privileged intermediary. As a matter of form, it is addressed to the bona fides of an SRO's representations to the Commission and to the public.

If the NYSE persists in this absolute insult to both the Commission and the public, this matter should be referred to the SEC's Office of Compliance Inspections and Examinations and the SEC's Division of Enforcement. Or perhaps a Congressional oversight committee needs to be made aware of this travesty.

A Brief History of the "Longstanding Interpretation"

In Amendment 5 to SR-NYSE-2004-05 (the NYSE's "hybrid market" proposal), submitted in June 2005, the NYSE acknowledged (quite properly so) that Rule 108 prohibited specialist parity acquisition trading, and that a formal rule amendment was required to remove this restriction. In that same document, however, the NYSE acknowledged that the practice was occurring anyway, even though the prohibition remained in the rule.

In its September 21, 2005 comment letter on Sr-NYSE-2004-05, the NYSE stated, for apparently the first time ever, that an "interpretation" of Rule 108 somehow made specialist parity acquisition trading legal, notwithstanding the statement three months earlier that Rule 108 prohibited such conduct. On October 25, 2005, the NYSE submitted (seeking immediate effectiveness) the first iteration of SR-NYSE-2005-74, in which the September "interpretation" had somehow morphed into a "longstanding interpretation" apparently premised on linguistic flim-flam about the meaning of the word "entitle."

I commented that the October submission failed in every way to substantiate the existence of a "longstanding interpretation", and failed to explain why "shall not be entitled" (the rule's plain, simple language) did not mean what it said, namely the expression of a simple, unqualified prohibition. I demonstrated that the NYSE proposal had not been "properly designated" as a rule interpretation, per the requirements of SEC Rule 19b-4, and was not eligible for immediate effectiveness. Rather, the NYSE would be required to re-submit the matter under the Commission's normal, prior public comment rule approval process.

The matter lingered at the Commission until December (no SEC approval), when, apparently prodded by the SEC staff, the NYSE attempted (with its usual aura of noblesse oblige when it deigns to acknowledge criticism) to respond to my comments. The NYSE provided dictionary definitions of the word "entitle", cited the canon of statutory construction and an NASD precedent, and unearthed broad, general background material from two early SEC studies of floor trading on U.S. exchanges.

In response, I demonstrated that the SEC studies did not address the precise issue under consideration, although the emphasis in both studies on the negative obligation clearly supported my position. I also demonstrated that the very dictionary definitions, canon of statutory construction, and NASD precedent cited by the NYSE in fact fully supported my position and completely undermined the NYSE's.

The NYSE's Latest "Response" to Criticism

The NYSE's latest attempt to "respond" to criticism is even more pathetic than its prior effort. The NYSE has made no attempt whatsoever to explain how it can possibly posit this "longstanding interpretation" when it had ackno wledged in June 2005 that Rule 108 prohibited the behavior in question. The NYSE has also failed to deal in any way with

my treatment of the dictionary definitions, canon of statutory authority, and the NASD precedent.

The NYSE's latest attempt at providing historical documentation is not only non-responsive, but introduces a new exercise in linguistic flim-flam involving the meaning of the word "restrict." The NYSE continues to provide general background information about the regulation of floor trading that does not refer in any manner to the Rule 108 question at issue. What the NYSE needs to produce (but obviously cannot, because it doesn't exist) is documentation showing that the general considerations stated in these historical documents led to the adoption of the specific interpretation at issue, premised on the meaning of "entitle." The NYSE simply cannot produce any linkage whatsoever between the general history (the underlying philosophy of wh ich does not support the current NYSE position anyway) and the specific "longstanding interpretation" now being foisted upon the Commission and the public.

Nothing demonstrates more clearly the NYSE staff's desperate air of "make it up as they go along" than their reference to a 1979 amendment to Rule 108 to permit specialists to compete directly with "G" orders (which are member orders, not public orders). Apparently, the NYSE staff just discovered this, as it was not part of their December submission, and thus presumably not instrumental in their devising of the "longstanding interpretation."

The NYSE's treatment of this material was obviously prepared by a non-lawyer, as it is a classic demonstration of the absence of focused legal reasoning. The NYSE quotes the following language from a 1979 rule submission it made, stating that the amendment was limited to "G" orders, and that "No changes are proposed with respec t to priority, parity and precedence based on size vis-a-vis orders of public customers."

By its own language, the NYSE said in 1979 the exact opposite of what the current NYSE staff are attempting to say. In 1979, the NYSE emphasised that it was changing the prohibition to permit specialists to compete with "G" orders, but was retaining the prohibition with respect to public orders. This is stated clearly and unambiguously in the very language quoted by the current NYSE staff. (This is also a classic demonstration of how the canon of statutory construction completely undermines the current NYSE staff's position. See my December 11, 2005 comment letter on this point).

The NYSE staff then go on to quote the following language from the 1979 "G" order rule submission: "In varying degrees, Exchange Rules 108 and 112 restrict bids and offers of specialists...from having priority, parity, or precedence based on size over ord ers initiated off the floor...The restriction primarily applies when a member is establishing or increasing a position as opposed to liquidating a position."

This is a clear-cut statement of a regulatory prohibition and I couldn't agree with it more. But wait, here comes the NYSE staff's linguistic flim-flam: "The use of the terms "restrict" and "restriction" instead of "prohibit" and "prohibition" is significant, as it reinforces the interpretation that Rule 108 does not, and was not intended to, "prohibit"

specialist parity, but merely to "restrict" it in certain situations - namely, where a broker objects to the specialist trading on parity."

Sound familiar? It's the exact same linguistic flim-flam the current NYSE staff is attempting to pull off about the meaning of the word "entitle." (The comments in my December 11, 2005 comment letter about "entitle" can easily be substituted here for "restrict"). In both instances, the current NYSE staff are attempting to state that a simple prohibition is somehow "qualified", even though the expression of the prohibition contains no hint of a qualification. The canon of statutory construction makes a mockery of the NYSE staff's position. And, of course, the NYSE staff cannot be bothered to deal with the fact that in June 2005 they acknowledged the Rule 108 prohibition and the need for a formal rule amendment. And nowhere does the NYSE staff provide background information dating specifically from the adoption of Rule 108 as to what the drafters of Rule 108 actually intended. (I submit the drafters' intention is manifest in the rule's simple, unambiguous language). And nowhere does the NYSE staff explain how a floor broker consent mechanism is somehow implied by a statement of a simple, unqualified restriction.

But it gets even better. In its June 2005 Amendment 5 to SR-NYSE-2004-05, the NYSE stat ed the following: "Currently, NYSE Rule 108 prohibits the specialist from trading for its proprietary account on parity with the Crowd in situations where the specialist is establishing or increasing a position. The Exchange proposes to amend NYSE Rule 108 to eliminate this restriction...." (Page 69 of Federal Register notice, emphasis added).

In other words, the NYSE clearly acknowledged in June 2005 that "prohibition" and "restriction" were synonymous terms (as well they should have). The current NYSE staff are simply "hoist by their own petard" here. Several months ago, the current NYSE staff clearly understood that "restriction" meant "prohibition", and that formal amendment to Rule 108 was required to remove the prohibition/restriction.

The NYSE staff's reference to the Floor Official Manual is similarly laughable. The Manual states that a specialist "must yield parity", with no accompanying langua ge to suggest that this prohibition is in any way qualified. As with the rest of this sorry mess, the canon of statutory construction completely undermines the NYSE staff's position.

I cannot imagine that the SEC staff have the stomach for much more of the NYSE's absolute nonsense here.

Why This Issue Is Important

One would have thought, in the wake of the recent specialist trading scandal, that the NYSE would be bending over backwards to regulate specialists strictly, and to put the interests of the public clearly ahead of specialist dealer interest. But regardless of whatever "tweaks" the NYSE may be making to its surveillance systems, the NYSE,

from a rulemaking standpoint, seems hell-bent on accommodating the specialist community's "wish list", presumably in return for the specialist community's support of the controversial "hybrid market." Not onl y, as herein, is the NYSE proposing to permit specialists to compete directly with the public, but, in its "hybrid market" proposal, the NYSE is proposing to give specialists exclusive, insider-trading like privileges to trade against most of the NYSE's systemic order flow (the "algorithmic" trading proposal). And, at the same time that it is proposing this radical expansion of specialist proprietary trading, the NYSE is also proposing a drastic reduction in specialist capital requirements. (See my comment letter on SR-NYSE-2005-38). This is shocking stuff. It's as though the NYSE is determined to reward specialists in ways previously unthinkable, rather than clamping down on them in the public interest.

The issue of specialist parity acquisition trading, though clouded by the technical nuances of an obscure rule, is in fact hugely significant. Specialist displacement of public orders is, in fact, a subtle form of "trading ahead" of the public to the public's economic detriment. As my December 17, 2005 comment letter demonstrated, specialist parity acquisition trading is strongly opposed by both the floor broker community and the NYSE's major customers (and I should include here as well my own clients, two major institutions), who obviously had never heard of the "longstanding interpretation."

Presumably because it knows it would provoke a firestorm of opposition if it proceeded under the normal rule approval process, the NYSE is positing its bogus "longstanding interpretation" as eligible for immediate effectiveness. Although this was originally submitted on October 25, 2005, the SEC staff, presumably smelling a rat, have held firm here and declined to give approval. In its latest submission, the NYSE notes its December resubmission of the proposal and adds the disingenuous parenthetical "(Federal Register notice pending)." It is not the "Federal Register notice" that is pending, it is the SEC approval order that would be published in such notice that is pending. But notwithstanding the absence of such approval, the NYSE went ahead, in late October, and issued the bogus Information Memo anyway. The NYSE is obviously flouting the law here, a truly appalling situation.

If the SEC's rule approval processes are to have any meaning, the NYSE must be directed to rescind that Information Memo, and to resubmit this entire matter under the Commission's normal, prior public comment process.

The Hypocrisy of the Floor Broker Consent Mechanism

In prior correspondence, I have demonstrated that the floor broker consent mechanism is, in real world terms, meaningless in the culture of the NYSE trading floor. In its latest submission, the NYSE makes the following statement: "In SR-NYSE-2004-05, Amendment No. 7, the Exchange clarified that by including a customer's order in the broker agency interest file, the broker waives his or her objection to the specialist trading

on parity with such order, with the result that the specialist may trade on parity in automatic executions."

English translation: The NYSE is acknowledging the meaninglessness of a floor broker consent mechanism by dispensing with it entirely if a broker wishes to represent (as he/she must) an order in the "hybrid market." This is the absolute epitome of a "forced waiver" if ever there was one, as the broker has no ability, in practical terms, to both object to specialist parity and participate in the "hybrid market."

The real answer, of course, is to prohibit specialist parity acquisition trading and insist that the public go first. Period. But how utterly hypocritical of the NYSE to assert that floor brokers can protect their customers in the physical auction, but cannot, as a practical mat ter, protect them in the hybrid market.

Conclusion

The time has come for the SEC staff to insist that the NYSE abandon the pretense of a "longstanding interpretation" and comply with the SEC's normal rule approval processes.

The NYSE's behavior in this matter has been shameful, and the more it tries to defend its position, the more egregious its misconduct appears.

Very truly yours,

George Rutherfurd
Consultant (to two institutional investing organisations)
Chicago, IL