

# Independent Broker Action Committee

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April 21, 2006

## VIA EMAIL

Nancy M. Morris, Esq.  
Secretary  
United States Securities and Exchange Commission  
Station Place  
100 F Street, NE  
Washington, DC 20549-9303

Re: Proposed Rule Changes by the New York Stock Exchange  
Relating to the Hybrid Market Proposal (File No. SR-NYSE-2004-05)

Dear Ms. Morris:

The Independent Broker Action Committee, Inc. ("IBAC") is a not-for-profit corporation whose membership consists of independent brokers on the floor of the New York Stock Exchange ("NYSE"). IBAC's membership includes over 100 active dues-paying members, reflecting the commitment and concern of the NYSE floor brokerage community with respect to the NYSE's proposals.

In File No. SR-NYSE-2004-05,<sup>1</sup> the NYSE submitted proposed rules and regulations for its "Hybrid Market," intended to marry the best of the electronic and extant auction markets. On March 22, 2006, by Exchange Act Release No. 34-53539, the Commission entered an "Order Approving [the] Proposed Rule Change and Amendment Nos. 1, 2, 3 and 5 and Order Granting Accelerated Approval to Amendment Nos. 6, 7 and 8 to the Proposed Rule Change to Establish the Hybrid Market" (hereinafter "the Order"). Notwithstanding the Accelerated Approval, the Commission nevertheless invited comment to, *inter alia*, Amendment No. 8. We write now to express IBAC's comments in regard thereto.

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<sup>1</sup> The file is supplemented by amendments No. 1 (submitted July 30, 2004), No. 2 (November 8, 2004), No. 3 (November 9, 2004), No. 5 (June 17, 2005), No. 6 (September 16, 2005), No. 7 (October 10, 2005) and No. 8 (March 14, 2006). Amendment No. 4 was withdrawn

We initially note our concern that Amendment No. 8 was approved on an accelerated basis without allowing pre-approval public comment. Amendment No. 8 is not just technical, but promulgates several material substantive modifications both (i) in changing the delicate balance between the NYSE Specialists and the auction market crowd and (2) in permitting phase in of the full Hybrid Market without the necessity of further Commission approval.

By comment letters dated December 7, 2005 and February 2, 2006, we expressed our concern that the Hybrid Market rules, as even then proposed, unfairly favored Specialists to the detriment of the investing public. This is because, among other things, the Specialists will have algorithmic trading capability (called "APIs") not available to the floor broker, and will be permitted to trade on parity even when opening or increasing a position. While the floor broker can block parity to a Specialist opening or increasing a position, that right is not available to interest in the Broker Reserve File. Rule 108. Thus, unlike the pre-Hybrid rules, in the Hybrid Market the floor broker can only block parity to a Specialist opening or increasing a position if the floor broker has a disclosed interest.

Amendment No. 8 goes even further in tipping the scales in favor of the Specialists, as a consequence of the following modifications made therein:

- Even where auto-ex and autoquote are suspended, the Display Book will accept Specialist algorithmic messages to layer the Display Book outside the published quote (the specialist can also layer manually within the quote). Rule 104(c)(6).
- Even when auto-ex is locked, autoquote will operate to update if the BBO is outside a momentum LRP that has not yet been reached. Rule 60(e)(iv)(a). This is important because the rules already provide that algorithmic trades will be accepted to improve or supplement the BBO even while auto-ex is locked or crossed if autoquote is operating. Rule 104(c)(vi)(i). Thus, the specialist will be able to algorithmically trade at the BBO or to price improve while everybody else is electronically locked out.
- The specialists' required "meaningful amount" in a bid or offer to enable it to price improve algorithmically is reduced to 500 (from 1000) shares in all but the 100 most active issues. Rule 104(e)(ii)
- The floor broker must be present in the crowd at the open to represent a pre-open registered interest. Rule 70.20(j)(ii).

IBAC believes that these advantages are inconsistent with a Specialist's duty to support a fair and orderly market (Rule 104) as its primary objective. The Commission's Order addresses this point (at pp. 107-108) in reliance on NYSE oral representations that "it will develop guidance to clarify how it expects Specialists to comply with NYSE Rule 104 in the Hybrid Market." Order, p. 108, n. 382. However, the key point here is that the Exchange represents that this will be done "prior to the rollout of the **third** phase of the Hybrid Market." *Id.* (emphasis added). But the Specialists' algorithms will be introduced in the **second** phase of the rollout. Amendment No. 8, p. 33. In other words, the Specialists will be given the algorithmic capabilities **before** the Exchange has prescribed limitations on their use to comply with the Specialists' statutory and rule requirement to use the algorithms to support a fair and orderly market. The algorithms will thus be in use for an extended period before anyone has any idea as to how their use should be circumscribed to permit the Specialists to perform their market stabilization function.

Recognizing the imbalance this circumstance *per force* creates, in both Amendments 5 (at 70 FR 37475 n. 13) and 6 (at p. 5), the Exchange stated its intent to provide "electronic price improvement" to the auction crowd "via a discretionary order type." Although this representation was first made in June 2005, almost a year ago, the Exchange has yet to live up to its promise. Thus, putting all the pieces together, Phase II of the "Hybrid Market" will look like this: The Specialist algorithms will be operating to the Specialists' clear advantage at the expense of the public investor, without limitation as to how this untrammelled algorithmic trading will impact market stability, and without the auction crowd having the promised tools to counterbalance the certain trading advantages of the Specialists' algorithms.

Moreover, by comment letter dated March 17, 2006, we advised the Commission of ongoing technical problems during the now completed hybrid pilot test period. These types of problems have continued unabated on, of course, a larger scale during the ongoing Phase I of the Hybrid Market rollout. We are in the process of preparing a compendium of known technological Phase I problems, which will be provided to the Commission as soon as it is completed. It appears intuitive to us that all technical problems should be resolved at each phase before proceeding to the next one. Nevertheless, the Exchange has failed to provide any assurance that this would be done before Phase II begins, and continues to represent that Phase II will commence "shortly," without providing any definitive guidance.

For these reasons, we urge the Commission to require that the Exchange obtain specific Commission approval before moving to Phase II, and that in the interim, the Commission seek public comment on, and review the effect of, Amendment No. 8 on the Hybrid Market. We firmly believe that Phase II should not go forward until, at the very least, the Exchange (1) establishes by rule how the Specialists are to fulfill their market stabilization function in the Hybrid Market, (2) creates the discretionary order types for

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the auction crowd, and (3) demonstrates that all Phase I technological problems have been resolved.

Respectfully submitted,

INDEPENDENT BROKER ACTION COMMITTEE, INC.

By:   
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Warren P. Meyers, President