

KURZMAN EISENBERG CORBIN LEVER & GOODMAN, LLP

ATTORNEYS AT LAW

ONE NORTH BROADWAY
WHITE PLAINS, NY 10601
TEL: (914) 285-9800
FAX: (914) 285-9855

OTHER LOCATIONS:
FORT LAUDERDALE, FLORIDA
LONDON, ENGLAND
GENEVA, SWITZERLAND

675 THIRD AVENUE 18TH FLOOR
NEW YORK, NEW YORK 10017

TEL: (212) 661-2150
FAX: (212) 949-6131

ANDREW J. GOODMAN
Partner
agoodman@kelaw.com

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December 8, 2005

VIA E-MAIL AND
VIA FEDERAL EXPRESS

Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303



Re: Proposed Rule Change by the New York Stock Exchange
Relating to NYSE Direct+ (File No. SR-NYSE-2004-05)

Dear Mr. Katz:

This firm represents the Independent Broker Action Committee ("IBAC") in connection with the above-reference matter. Enclosed herewith is IBAC's comment letter relating to File No. SR-NYSE-2004-05.

Please direct to me all further communications regarding the above matter.

Very truly yours,

A handwritten signature in black ink, appearing to be "AJG", written over a horizontal line. Below the signature, the name "Andrew J. Goodman" is printed in a standard font.

AJG/jsl
Enclosure

cc: Mr. Warren Meyers

Independent Broker Action Committee

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Website: www.IBAC.us

December 7, 2005

Mr. Jonathan G. Katz
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303



Re: Proposed Rule Change by the New York Stock Exchange
Relating to NYSE Direct+ (File No. SR-NYSE-2004-05)

Dear Mr. Katz:

Independent Broker Action Committee, Inc. (IBAC) is a recently formed not-for profit corporation whose membership consists of independent brokers on the floor of the New York Stock Exchange (NYSE). IBAC was formed for the purpose, among others, of reviewing and commenting on the NYSE's proposal to establish a so-called "hybrid market." In the short time of its existence, IBAC's membership has already grown to over 100 dues-paying members, reflecting the commitment and concern of the NYSE floor brokerage community with respect to the NYSE's proposals.

Introduction

Perhaps more than any other constituency that operates on the NYSE floor, independent floor brokers – who act as agents in executing orders to buy or sell stocks on behalf of clients – represent the interests of the investing public. It is with these interests in mind that IBAC respectfully requests that the Commission not approve the NYSE's proposed rules effectuating the hybrid market (collectively, the "Proposal") in their present form. The Proposal is embodied in several proposed rule filings the NYSE has made to the Commission.¹

¹ The filings that are open (i.e., not replaced or withdrawn) are Amendment No. 1 (submitted July 30, 2004); Amendment No. 2 (Nov. 8, 2004); Amendment No. 3 (Nov. 9, 2004); Amendment No. 5 (June 17, 2005); Amendment No. 6 (Sept. 16, 2005); and Amendment No. 7 (Oct. 10, 2005). All of these are available at <http://www.nyse.com/marketinfo/hybmarket/1128991362347.html>. To date, neither Amendment No. 6 nor Amendment No. 7 has been published in the Federal Register.

We urge disapproval on two grounds, as detailed below. First, the Proposal is materially incomplete, in that, while it details the mechanisms and methods by which specialists will execute trades using specially designed algorithms, it does not contain any information as to the mechanisms and methods that floor brokers will be permitted to use to trade systematically with incoming electronic orders. The NYSE has promised to include such information in a supplemental filing, but no such filing has yet been made. Second, as discussed below, the Proposal is materially detrimental to the interests of the investing public in a fair and competitive auction market.

We also set forth below an alternative hybrid market proposal, which incorporates most of the elements of the NYSE's Proposal, yet alters it in such a way so as to cure many of the deficiencies we cite herein.

The Auction Marketplace and the Role of the Floor Broker

Throughout its history, the NYSE has operated predominantly as an auction market. The face-to-face auction market has long been recognized as the hallmark of the NYSE's success. As the NYSE itself recently stated:

Independent research shows that auction representation dampens volatility and lowers trading costs, particularly in periods of market stress or order imbalances. The auction model differentiates the NYSE from other markets and provides more stability and significant savings in trading costs.²

Consequently, "Nasdaq trades face higher liquidity costs than similar NYSE trades."³

Floor brokers play a vital role in the NYSE auction process. Summarizing relevant studies in their 2004 article, The Economic Value of a Trading Floor: Evidence from the American Stock Exchange, Professors Puneet Handa and Ashish Tiwari (of the University of Iowa) and Robert A. Schwartz (of Baruch College of the City University of New York) noted:

[A 1997] analysis of floor broker participation on the NYSE, find[s] that floor brokers do contribute additional liquidity. [A 1992 study] point[s] out a further advantage of a floor-based trading system: it gives participants the opportunity to observe who trades with whom, how urgently they seem to want to trade, etc. There are a number of other ways in which a floor trader may add value: (a) the trader might obtain knowledge of the presence of a contra party, mitigating price impact; (b) the trader could "round up" multiple counter parties, again cushioning the impact by trading in what may be viewed as a spontaneous call auction;

² NYSE summary of the Hybrid Market (Exhibit "A").

³ Robert Battalio, Brian Hatch and Robert Jennings, Dimensions of Best Execution for Market Orders: Assessing Differences between the NYSE and the Nasdaq Third Market, March 2000 (paper delivered at NYSE conference), at 4.

(c) the trader could anticipate periods when liquidity is high and trade more often in larger sizes during such periods; (d) the trader could avoid trading periods when trading is low; and (e) the trader may possess superior ability to read momentum in the market and to time trades accordingly.⁴

Floor brokers are perhaps even more critical when electronic systems malfunction, as they inevitably do on occasion, and as they recently did on June 1, 2005 and November 30, 2005.⁵

Specialists, too, serve critical functions in the auction market: as trade facilitator, managing the auction process and acting as catalyst to bring together buyers and sellers; as agent for customer orders; and as liquidity provider, providing stabilizing capital, but only as agent of last resort.⁶ Counterbalancing their role as liquidity provider is the specialists' "negative obligation," which prohibits them from trading for their own account when public orders can be matched together.⁷

In 2000, the NYSE launched NYSE Direct+, an automatic execution facility, as a pilot program. To date, the impact of NYSE Direct+ has been limited by restrictions providing that NYSE Direct+ can be used only for limit orders, and only up to a volume of 1,099 shares, and that only one NYSE Direct+ order can be entered for the same customer in any 30-second interval.

In seeking Commission approval to expand NYSE Direct+ and implement the Proposal, the NYSE has claimed that the hybrid market will maintain all the positive attributes of the auction market, while incorporating additional electronic benefits:

[T]hese proposals create a unique, integrated market – a hybrid market – that uses technology to improve the speed and efficiency of the auction, while preserving the advantages of human knowledge and expertise that are central to the Exchange market.⁸

Unfortunately, as explained below, in its present form the Proposal does no such thing, but rather thwarts the auction market and jeopardizes the stability and price improvement it has long provided.

⁴ University of Chicago Journal of Business, Vol. 77, No. 2 (April 2004).

⁵ See "Malfunction Briefly Halts Trading on Big Board," New York Times, June 2, 2005 ("Yesterday's breakdown puts the exchange's recent shift to more electronic trading in something less than its best light.")

⁶ See NYSE Hybrid Training Program e-mail from NYSE, Vol. 12 (Nov. 4, 2005) ("NYSE Hybrid E-mail Vol. 12"), at <http://www.nyse.com/marketinfo/hybmarket/1131104410538.html>.

⁷ See Exchange Act Section 11A(a)(C)(v).

⁸ NYSE Hybrid Proposal Amendment No. 5, Exchange Act Release 51906 (June 22, 2005), 70 FR 37463 (June 29, 2005), at 37475.

The NYSE's Hybrid Market Proposal, Including Specialist Algorithms and Parity

The Proposal would, among other things, expand NYSE Direct+ so as to (i) accept orders of all sizes (electronic orders would no longer be capped at 1,099 shares); (ii) eliminate the 30-second restriction between orders; (iii) allow for market orders (not just limit orders) to be executed electronically; and (iv) allow traders to “sweep the book” within a specified range. As a result, the role of automatic executions in NYSE trading would expand enormously. While approximately 10 percent of total NYSE volume is presently executed automatically via Direct+,⁹ the NYSE's proposed rule filings demonstrate that the NYSE intends that automatic execution will become the norm, rather than the exception.

Significantly – and, in our view, detrimentally, as discussed below – the Proposal would, in two ways, greatly expand the role of specialists' proprietary trading. First, specialists would be permitted to trade for their own account with incoming orders using proprietary algorithms (software programs) that will evaluate incoming orders and determine whether actions should be taken. The specialists' algorithms will use the Specialist API (Application Programming Interface), an electronic conduit owned and maintained by the NYSE, to receive information on incoming orders and automatically place quotations or trades on behalf of their dealer accounts.¹⁰

Second, under the Proposal, specialists would be entitled to trade on parity with the crowd when opening or increasing the specialist's proprietary position. The current parity rules do not provide such an entitlement, and thus limit the ability of specialists to use their information and speed advantages vis-à-vis other market participants. In this way, the current NYSE rules have helped to maintain a fair auction market. Under the Proposal, however, as the NYSE stated in June 2005, specialists would no longer be prohibited from trading on parity when opening or increasing positions:

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 its position. The Exchange proposes to amend NYSE Rule 108 to eliminate that restriction and provide that specialists would be entitled to parity with orders represented in the Crowd and agency interest files when establishing or increasing its position.¹¹

The NYSE acknowledged that thus changing its rules to entitle specialists to trade along with public customers “represents a shift from the overall scheme of priorities on the Exchange Floor.”¹²

⁹ See NYSE website, “Technology,” at <http://www.nyse.com/about/technology/1091792165957.html>.

¹⁰ See NYSE Hybrid E-mail Vol. 12, *supra*.

¹¹ NYSE Hybrid Proposal Amendment No. 5, 70 FR 37463 at 37479.

¹² *Id.*

However, in Information Memorandum (“IM”) 05-81, issued on October 26, 2005, the NYSE seems to have downplayed the significance of its proposed parity rules. In that IM, the NYSE stated that its long-standing interpretation of NYSE Rule 108(a) was that specialists are permitted to trade on parity with the crowd even when establishing or increasing their positions, provided that the brokers in the crowd do not object. However, the NYSE did not appear to reconcile this position with its prior statement that Rule 108 “prohibits” such conduct. Thus, its proposed rule change seems to clearly shift the overall scheme of priorities on the floor. In any event, under the NYSE’s current position, the IM imposed additional, time-consuming requirements on any brokers who choose to object to a specialist’s parity trades.

The NYSE’s Hybrid Proposal Should Be Disapproved As Incomplete Because the NYSE Has Not Developed a Provision Providing for Systematic Trading by Floor Brokers

One of the NYSE’s stated goals for the hybrid market is to promote enhanced competition among market participants. But by providing for algorithmic trading by specialists, while providing no facility for floor brokers to trade systematically with incoming electronic orders, the Proposal, as it stands now, is one-sided and would thwart, rather than foster, fair competition.

As the Investment Company Institute (ICI) stated in its July 20, 2005 comment letter on the Proposal to the Commission:

Specialists, via the proposed specialist algorithm, would be permitted to send messages to the display book to quote or trade in reaction to specified types of information including, among other things, “incoming orders as they are entering NYSE systems.” The Institute opposes providing specialists with the ability to electronically “see” certain information before other market participants and to make quoting and trading decisions based on that information by, in particular, providing “price improvement” to incoming orders. Having the ability to see orders as they enter NYSE systems, and therefore before they reach the display book, creates an information advantage for specialists.

So as to counteract the advantages that algorithmic trading would provide specialists, and thereby help ensure a level playing field, the NYSE has repeatedly promised to submit to the Commission a revised rule filing that would provide floor brokers with their own ability to trade systematically with incoming orders. Specifically, in its Amendment No. 5 filing in June 2005, the NYSE stated as follows:

It should be noted that the Exchange intends to provide Floor brokers with the ability to provide electronic price improvement via a discretionary order type. This will be the subject of a separate filing.¹³

¹³ NYSE Hybrid Proposal Amendment No. 5, 70 FR at 37475 n.13; see also *id.* at 37478.

The NYSE reiterated this promise in its Amendment No. 6 filing in September 2005.¹⁴ But to date the NYSE has made no such filing. In the absence of such a filing, it is impossible for floor brokers – or the Commission – to evaluate the adequacy of anything the NYSE may propose on this matter.

As set forth in the Exchange Act, the Commission’s evaluation of the proposed new rules is to be measured by standards such as that the rules of any self-regulatory organization (SRO) (i) must be designed “to protect investors and the public interest” and not be designed “to permit unfair discrimination between customers, issuers, brokers, or dealers”;¹⁵ and that they (ii) must not impose an unnecessary or inappropriate burden on competition.¹⁶

As set forth in SEC Form 19b-4, an SRO’s rule filing must be sufficiently complete to allow the public to provide meaningful comment on any proposed rule change. Exchange Act Section 19(b)(2) provides that the SEC shall approve a proposed SRO rule change if it finds that the proposed change is consistent with the statutory provisions and rules and regulations applicable to the SRO. Conversely, Section 19(b)(2) provides that, absent such a finding, the SEC shall disapprove of the proposed rule change.

Here, because of the NYSE’s failure to submit a rule filing on a critical piece of the puzzle – that is, how floor brokers will be permitted to trade in such a way as to provide competition for specialists trading algorithmically – no finding that the hybrid market proposal is consistent with the Exchange Act and the rules and regulations thereunder is possible. Approving the Proposal – based in part on the NYSE’s assurance that it will subsequently fix a major problem with the Proposal as it exists today – would be the equivalent of “buying a pig in a poke.” Instead, the Commission should not approve the Proposal, at least until the NYSE has supplemented its proposed rule filings as it has promised, and there has been a subsequent adequate period in which interested persons may comment on the revised Proposal.

The Proposal’s Provisions on Parity and Specialist Algorithms Would Cause Unfair Discrimination, Unduly Burden Competition, and Harm Public Investors

Before we address two specific issues we have with the Proposal, it bears mentioning that our concern is not with the specialists, with whom the crowd has always worked cooperatively, but rather our concern is with a proposed system that would force this relationship to change dramatically. We believe that the specialists render their current functions well in close cooperation with the floor brokerage community, and we believe it would be a mistake to promulgate rules that would compel the alteration of the existing dynamic.

¹⁴ See NYSE Hybrid Proposal Amendment No. 6 (Sept. 16, 2005), at <http://www.nyse.com/pdfs/2004-05am6.pdf>, at 5.

¹⁵ Exchange Act Section 6(b)(5).

¹⁶ Exchange Act Section 6(b)(8).

As indicated above, the Commission should approve proposed NYSE rules only if it finds that they, among other things, are designed to protect investors and the public interest, not designed to permit unfair discrimination, and do not impose an unnecessary or inappropriate burden on competition. Unfortunately, the Proposal as it stands today fails these tests.

One of the primary flaws in the Proposal is the provision placing specialist orders to open or increase their positions on parity with the crowd. By nature of their position, specialists have inherent information and speed advantages in the marketplace. One primary check on the specialists' ability to use these advantages, and thus one primary mechanism for ensuring fair competition in the market, has been the provision under which specialists are not entitled to parity when opening or increasing their positions. Lifting that restriction would tilt the playing field, in favor of the specialists and to the detriment of floor brokers and, more importantly, to the detriment of floor brokers' customers.

While it is true that specialists have long been permitted parity in liquidating or reducing a position, that is very different from opening or increasing a position. With the former, the specialist is maintaining stability by adding liquidity to the market. In regard to the latter, the specialist is removing liquidity and enhancing volatility. Entitling the specialists to parity when opening or increasing positions would thus have the added negative consequence of increasing volatility in the market.

As indicated in the quotation above, the NYSE stated in its June 2005 filing that this change in parity rules would impose a "shift from the overall scheme of priorities on the Exchange Floor." Indeed, the specialist's role would be largely shifted from its traditional one of auction facilitator to being much more of a market competitor. The specialist's "negative obligation" would thus be turned on its head, as specialists would be permitted to use their information and speed advantages to participate in proprietary trading to a much greater extent than they are today. Once again, we join with the ICI's position on this issue:

The Release notes that the proposed change [in parity rules] would increase the instances in which the specialist would be entitled to trade along with public customers and represents a shift from the overall scheme of priorities on the Exchange floor. The Institute opposes eliminating this restriction. Placing specialists trading for their proprietary account on parity with investor orders misaligns the interests of participants on the Exchange and, as such, is likely to contribute to the ineffectiveness of the hybrid system as a whole.

Even if one accepts the position that the NYSE stated in IM 05-81, that would not change the central point here. Granting the specialist an entitlement to parity, in conjunction with the speed of algorithmic trading, would give the specialist an advantage over the crowd (and thus the public) that it does not presently enjoy. Simply put, the new rules would enable the specialist to execute algorithmically at parity with the book before a

floor broker could compete by putting in a new, price improved order, thereby depriving the public of price improvement otherwise available in an auction market.

A second primary flaw in the Proposal is the provision allowing specialists to trade algorithmically with incoming orders, thereby greatly increasing the specialists' speed advantage.¹⁷ Here, too, the Proposal would dramatically tilt the playing field toward the specialists and away from the investing public, as represented by their agents, the floor brokers. This flaw will exist at least until the floor brokers have a corresponding ability to interact with incoming orders – and such ability has been demonstrated to be equally effective as the powerful tool the Proposal affords the specialists.

The NYSE has suggested that floor brokers will be able to mitigate the impact of specialist algorithmic trading by entering bids and offers into the new Broker Agency Interest File. But this would be an ineffective solution. As explained by one of the NYSE's most experienced floor brokers, a former floor governor, forcing floor brokers to enter their orders in advance, in anticipation of market developments, would vitiate the floor broker's effectiveness on behalf of his or her customers:

Good brokers have always had an execution game plan and an ability to instantly react to both anticipated and unanticipated trading opportunities consistent with such plan. Great brokers constantly modify their execution game plan affording great savings and flexibility to their institutional clientele. The hybrid will force brokers to enter orders in the broker interest files with price and volume discretion that represent their current execution strategy.... This means that every time your broker modifies his or her strategy, he must cancel his orders and re-enter new ones. Even with modern technology, changing your orders is much slower than changing your mind.¹⁸

This problem is exacerbated because the NYSE proposal permits algorithmic trades to sweep the entire book, including reserves (thus adding to volatility by extending the reaction to short term news) and auction market and limit orders. Moreover, Floor Broker Agency Interest files must yield to the Display Book. As Commissioners Glassman and Atkins, in their dissent to the adoption of Regulation NMS, relevantly note that full depth of book electronic trading would be “the death knell for floor-based exchange trading.”¹⁹

¹⁷ The NYSE stated in its Amendment No. 5 filing that it will seek to neutralize the specialists' advantage by imposing a certain time delay in algorithmic processing, and thus “make certain that such messages are processed by the book in a manner that gives specialists and other market participants a similar opportunity to trade with the Exchange's published quotation.” 70 FR at 37477. But the NYSE has not indicated the length of this delay. Especially given the technological edge that specialists' machines have over the floor brokers' handheld machines, any such delay is highly unlikely to create a truly level playing field.

¹⁸ Richard Rosenblatt and Joe Gawronski, Trading Talk: Market Structure Analysis & Trading Strategy (newsletter of Rosenblatt Securities Inc.), July 28, 2005 (“Rosenblatt Newsletter”), at <http://www.rblt.com/documents/7-28-05Hybrid5final.pdf>, at 6.

¹⁹ Regulation NMS (dissent), Exchange Act Release 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005), at 37638.

Perhaps in recognition of these concerns, the Proposal includes purported protection of the auction market. In our view, these supposed safeguards will be wholly ineffective. First, the specialists' algorithms will not be permitted to view the broker's reserve interest. But the reality is that the specialist observes precisely what is going on in the crowd, can therefore ascertain true interest without resort to the reserve book and can adjust the algorithm parameters accordingly. Moreover, the reserve book as presently proposed is of limited utility, because each floor broker's reserve is limited to five contiguous panels. In any event, the algorithm is not transparent to the crowd, so the ameliorative effect of any delay would be minimal, since the crowd will not be able to react to the algorithm and its effects on pricing.

As a result of these issues, the Proposal is likely to be counterproductive, and in fact provide a disincentive for customers to place orders at the NYSE. As expressed by the ICI, the trade organization of many of the NYSE's large buy side customers, in its July 20, 2005 letter to the Commission:

Allowing specialists to electronically interact with incoming orders in this manner and, in effect, step ahead of investor orders on the Exchange's limit order book, runs counter to the NYSE's goal of providing incentive to investors to place orders on the Exchange. Our members report that they are much more likely not to post orders on the Exchange due to the ability of specialists to electronically interact with orders through this mechanism.

The specialist function would thereby be transformed from maintaining market stability in cooperation with the crowd, to one that looks and feels very much like a Nasdaq market maker buying primarily as principal solely through electronic transactions. The difference is that Nasdaq securities generally have a number of market makers, while each NYSE-listed security is assigned only a single specialist. Nasdaq best execution is aided by its market maker competition; with a single monopolistic trader per listed security, the NYSE's ability to offer best execution could be severely circumscribed, in derogation of competition.

Modifying the Proposal by Retaining Present Parity Rules and by Providing Floor Brokers with the Ability to Engage in Systematic Electronic Trading Would Create a Hybrid Market that is More Effective and Better Suited to the Public Interest

In the event that the Commission is inclined to allow the NYSE to adopt and implement some version of a hybrid market, we submit that the Proposal as it stands now would be significantly improved if two "fixes" were incorporated into it. We respectfully note that the Commission has the legal obligation to consider facially reasonable alternatives to proposed rules.²⁰ Any alterations to the current Proposal, we also note, should be embodied in a new proposed rule filing by the NYSE, with the public provided the

²⁰ Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

opportunity to comment, before the Commission should consider adoption of the Proposal.

Specifically, we propose retaining present parity rules and putting effective electronic price improvement in the hands of the floor brokers. This solution has been voiced by NYSE customers, the brokerage community, and indeed previously by the NYSE itself (inconsistently with its present Proposal). We view retaining the present parity rules as fundamental to retaining the parties' current and appropriate roles in the market. In particular, retaining the present parity rules would help maintain the specialists' role as marketplace facilitator, rather than placing the specialist in competition with and thus hurting the investing public.

As for providing floor brokers with the means to interact systematically with incoming electronic orders, we join in the views of the above-cited floor broker, who has previously identified such a step as a necessary alternative to the current Proposal:

The glaring omission is algorithmic interaction by agents with the incoming order flow.... Agents must be given the ability to view incoming orders and react by improving price and volume for those orders if the new hybrid is to have any hope of achieving the high level of market efficiency available today on the floor of the NYSE.²¹

But unless and until electronic price improvement is in the hands of the floor brokers to be utilized ahead of electronic algorithms (at least insofar as a specialist is opening or increasing a position) granted by rule solely to the specialists, this basic vision is unattainable. We respectfully contend that permitting the hybrid market to operate in its proposed form, before the floor brokers have effective electronic price agency improvement at the ready, would put the auction market as we know it today at real risk, and could put forever beyond reach the vision of Congress, the Commission and indeed the NYSE itself of a true hybrid market combining the best of human agency representation and current technology.

Conclusion

The hybrid market Proposal as it exists under the latest amendments by the NYSE continues to be materially incomplete and materially flawed. We respectfully submit that no hybrid market proposal should be considered until the NYSE supplements its existing submissions with – and the public has the opportunity to comment on – a full explanation of the means by which floor brokers would be enabled to engage in systematic electronic trading, in fair competition with the new algorithmic trading facility provided to specialists.

In the absence of any such supplemental filing, the provisions in the present Proposal – on parity and specialist algorithmic trading – would seriously damage the effectiveness of the auction market, hinder competition, and harm the interests of the investing public. As

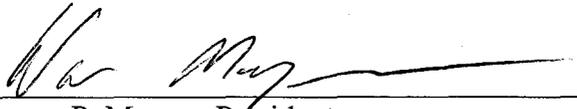
²¹ Rosenblatt Newsletter, supra, at 6.

noted above, floor brokers act as agents on behalf of the public, and it is the public's interests that must be paramount.

We request the opportunity to meet with the Commission regarding these issues.

Respectfully submitted,

INDEPENDENT BROKER ACTION COMMITTEE, INC.

By: 

Warren P. Meyers, President