

March 7, 2006

Dear SEC:

The NYSE's comment letter of February 28, 2006, while purporting to address criticisms I had made of its proposal, is largely a "non-responsive response." For the most part, as I demonstrate below, the NYSE has simply re-stated (with some amplification at times) its original positions, but has not joined issue with the substance of my critique, which focuses on financial failure/systemic risk, not the simple requirements of "calm seas" market making.

The NYSE continues to refuse to provide clearly material information (thereby effectively concealing what is a huge reduction in specialist capitalisation), has failed to discuss its proposed capital reduction in light of what actually happened during the 1987 crash, and has completely ignored the issue of systemic risk in the event of the financial failure of one or more specialist organisations, the critical consideration that led to the establishment of current capitalisation levels.

For whatever reason, the NYSE appears to have farmed this matter out to its net capital rule staff, even though (and for good reason, as I discuss below) neither the NYSE nor the SEC has ever viewed specialist capital requirements as a net capital rule issue. The NYSE has always codified its specialist capital requirements in Rule 104, and, more recently, in its Specialist Combination Policy rule (Rule 123E) because of the broad public policy interest (indeed necessity) in protecting the viability of the NYSE's market making system as a whole.

The current NYSE proposal, as articulated, reflects no familiarity with how stocks actually trade during a crash market (as opposed to normal declines), no familiarity with how the affirmative obligation devastates specialist capital in a crash market, and no familiarity with Rule 123E 's emphasis on minimising systemic risk arising from the financial failure of one or more specialist organisations. Indeed, the NYSE proposal, as articulated, reflects no familiarity whatsoever with what appears to have been a very deliberative process, carefully overseen by the SEC, to establish the current levels of specialist capitalisation in light of the highly concentrated risk accruing from the consolidation of NYSE specialist organisations.

The deliberative process that led to the establishment of current levels of specialist capitalisation focused on the need to protect the NYSE's market making system and to assure the investing public that the NYSE had an effective process for managing concentrated risk. (This is clear from NYSE rule submissions and SEC approval orders). Current levels of specialist capitalisation thus focus on broad public policy concerns, not the technical minutiae of the net capital rule.

The Commission is on clear notice hear. As I demonstrated in my January 13, 2006 comment letter, the NYSE specialist system is, in fact, significantly less well capitalised today to withstand a crash market than it was in pre-crash 1987.

Under this circumstance, the NYSE's proposed reduction in specialist capitalisation is absolutely unthinkable. Indeed, the only course of action that will reassure the investing public as to the viability of the NYSE's market making system is to revise capitalisation requirements upward to reflect significant increases in trading volume developing after existing requirements were put into place.

### Systemic Risk and the Self-Insurance of the NYSE Specialist System

As I noted in my January 13, 2006 comment letter, a singular failure of the NYSE's rule submission is the absence of any discussion whatsoever of a crucial consideration in the Specialist Combination Policy, the minimisation of risk of failure of the specialist system itself, not simply the risk that an individual specialist organisation will fail. The public record demonstrates the NYSE's and SEC's concern that the concentrated risk arising from specialist mergers be carefully overseen. Indeed, Rule 123E(b)(2)(ii) is specifically addressed to "minimizing both the potential failure and the negative consequences of any such failure on the specialist system as a whole."

From the standpoint of minimising financial risk in a crash market, it is crucial to consider the capitalisation of the system as a whole, not simply the capitalisation of any particular specialist organisation. This is so because of the unique way that the NYSE's specialist system self-insures against the risk of failure of any individual specialist organisation. Simply put, if one organisation fails, its stocks are reassigned to other specialist organisations (regardless of the financial strain those organisations may be then under). Thus, in a crash market under the NYSE's self-insurance system, there must be sufficient system-wide financial reserves so that "surviving" organisations (under severe stress themselves) can not only fulfill their own affirmative obligation-driven market making obligations, but can also assume the same obligations with respect to a failing organisation's stocks.

In pre-crash 1987, when the NYSE had 55 specialist organisations, all relatively small, the risk of the failure of an individual organisation to the entire system was manageable, and there was a relatively small "slack" to be absorbed by a large number of other organisations. Today, however, the NYSE has only seven equity specialist organisations (five of which trade most of the stocks) and the impact of financial failure of any of the NYSE's large specialist organisations would have a severe financial impact on the "survivors", who themselves would be highly stressed.

In the worst case scenario, in the NYSE's universe of only seven equity specialist organisations, one organisation could conceivably, in a crash situation, have to make an affirmative obligation-driven market in every single NYSE-listed stock. To mitigate the prospect of such a disastrous happenstance, the NYSE and the SEC have, in the Specialist Combination Policy, insisted that, at a minimum, there be no diminution in system-wide capital when specialist organisations merge.

In its February 28, 2006 "response", the NYSE makes a statement that is absolutely breathtaking in its ignorance: "Current Rule 123E(f)(i) does not recognize the benefits derived from such combinations and clearly imposes a penalty equal to the excess capital that existed in each specialist organization prior to the merger. In fact, because of the "marriage penalty", the capital requirements for today's seven equity specialist organizations represent the combined amount of net liquid assets of the 25 specialist organizations that since 2000 were merged, consolidated, acquired, or combined."

It is difficult to know where to begin with this. The NYSE (and presumably the SEC as well, in approving the Combination Policy) took great pains to ensure exactly the result that the NYSE is now complaining about. The NYSE has consistently insisted that there be no diminution in system-wide capitalisation because such capitalisation is, in effect, the self-insurance fund. The NYSE was being prudent here: the primary market would not reduce its "insurance fund" at the same time that risk was becoming more significant (by being more concentrated). The post-2000 result that the NYSE is now complaining about is exactly the result that the NYSE (and the SEC in its approval orders) told the investing public would happen and should happen. And, thankfully, it has happened, or the NYSE's ability to withstand a crash market would be even weaker than it is today. (More below on why there really is no marriage "penalty").

The end result here (no diminution of specialist system capitalisation) is sound public policy, even if specialist organisations perceive they are burdened with "excess" capital. The ultimate issue here is not a specialist organisation's (in isolation) capital requirement, but the strength of the system as a whole. Quite simply, the NYSE's self-insurance approach places "insurance risk" on each of its specialist organisations, and that is why, in the public interest, they are required to assume an additional financial burden.

It is inconceivable to me that the NYSE could purport to "respond" to my comments, but completely ignore this point, a central issue in the discussion. In the event, the NYSE's sudden reversal here, in which the NYSE is attempting to go from a broad public policy/interest perspective to a green eyeshade, bean counting net capital rule approach, is a classic instance of the NYSE's failing to see the forest for the trees.

### The 1987 Crash and Current Levels of Specialist Capitalisation

The discussion above concerning specialist system capitalisation as, in effect, the NYSE's self-insurance fund would be largely academic if the NYSE's proposed 40 percent reduction in specialist system capitalisation nonetheless left the system with more than adequate capital in the event of a crash/severely stressed market. But as I demonstrated in my January 13, 2006 comment letter (and demonstrate below), the exact opposite is the case even under current levels of capitalisation, much less under the proposed huge reduction. In that letter, I demonstrated, using the NYSE's own net liquid assets figures, that the NYSE specialist system is severely under-capitalised in terms of being able to respond to likely crash market volume. I noted in particular how ratios of trading volume

to net liquid assets are particularly adverse today compared to pre-crash 1987 and the NYSE's experience during the 1987 crash.

It is worth spending some time on the NYSE's attempted "response" here, as the NYSE has made unsupportable assertions regarding my ratio analysis, suggested that I do not understand or have disregarded the distinction between a specialist organisation's net liquid assets and buying power, and observed that the financial profile of specialist organisations today is different from that existing in 1987. These points are discussed below.

## 1. The Correlation between Trading Volume and Capitalisation

The NYSE contends, contrary to my position in my January 13, 2006 comment letter, that there is no longer a direct correlation between the level of daily trading volume and the amount of specialist capital required. In the NYSE's view, the increase in the level of average daily trading volume today is indicative of greater liquidity, greater stability and resiliency, and greater opportunities for the specialist to hedge or liquidate positions.

The NYSE's statements do not appear to have been written by anyone with a practical, working knowledge of how markets actually function. The NYSE's statements are naive at best, dangerous at worst, and call to mind the general babblement about how "new paradigms" had eliminated the prospect of market crashes just before the Nasdaq bubble burst.

In normal markets, including normal declines and advances, it is difficult to state with mathematical precision an exact correlation between overall market volume and the exact amount of capital required to make markets in relation to that volume. One knows intuitively, however, that in such "normal" markets, there will be greater specialist trading activity as overall market volume increases. This intuition is borne out by the NYSE's own statistics on its website. Compared to 1987, trading volume has increased significantly, and specialist dealer participation rates have also increased significantly.

A prudent regulator will obviously consider overall market volume in determining appropriate levels of market maker capitalisation. The NYSE states (page 4 of "response") that "there is no longer a direct correlation between the level of daily trading volume and the amount of specialist capital required." But the NYSE itself does not fully believe this. The NYSE's proposed methodology for computing specialist capital requirements calls for "\$1,000,000 for each one tenth of one percent (.1%) of Exchange transaction dollar volume...." Thus, while the NYSE disparages the notion of a "direct correlation" between volume and capital, the NYSE has nonetheless made such a correlation the centerpiece of its proposed methodology.

The NYSE's comments about greater liquidity, stability, and resiliency in today's markets, as well as greater opportunities for the specialist to hedge or liquidate positions, are, essentially, meaningless truisms for normal markets, including normal market declines and advances. Indeed, as I noted in my January 13, 2006 comment letter, the

specialist business on the NYSE is not particularly risky under most market conditions. Specialists are, essentially, in-and-out day traders who constantly "flip" positions with the objective of being as "flat" as possible at the end of the day.

The picture changes dramatically with respect to crash markets, where the correlation between trading volume and specialist capital becomes much more significant. What the NYSE fails to acknowledge and discuss is the inherent difference between the trading dynamics for an affirmative obligation-driven specialist in a crash market, versus the trading dynamics of a largely negative obligation-constrained specialist in a normal market, including normal market declines and advances.

In this regard, the NYSE's attempt to suggest that its "study" of normal market declines is a predictor of capital demands upon specialists in a crash market is so egregiously misguided as to constitute a major intellectual embarrassment for the NYSE. It is as though the NYSE were suggesting that the ability to easily weather a summer thunderstorm is the same thing as the ability to easily weather Hurricane Katrina.

In normal markets, including the normal market declines studied by the NYSE, the specialist is not faced with a surge in volume that is a significant multiplier of average daily trading volume. But the problem is not simply that volume has significantly multiplied. It is the nature of that volume as well. In crash markets, the huge upsurge in volume will be largely on one side of the market, with inordinate stress then being placed upon an affirmative obligation-driven specialist. Because of the largely one-sided nature of the massive volume, the specialist will be assuming much larger positions than usual, and with significantly fewer opportunities to "flip" those positions and recapitalise. And such recapitalisation opportunities as do arise will almost certainly involve recapitalisation at large losses. The result, as in 1987, is devastation of the specialist system's capital base.

The notion that sophisticated risk management tools can mitigate risk under the affirmative obligation in such situations is seriously misplaced. VaR models simply do not address "event risk" (a typical trigger of a crash market). The fact that a specialist may have perfectly offset the risk of an existing portfolio using a VaR model is entirely irrelevant when a crash hits.

And the notion that specialists can hedge the huge positions they have to assume in a crash market (as they can in normal declines/advances) is also seriously misplaced. In a crash market, the cash and derivatives markets become unlinked (as happened in 1987). Simply put, offsets become unavailable, or economically unfeasible, until the dust settles, at which point specialist organisations may have already traded themselves out of existence (as happened to at least one firm in 1987).

The fundamental error the NYSE is making is viewing a crash market as similar to the market declines it studied, but only more pronounced. In fact, a crash market is qualitatively, and inherently, different, particularly in a unitary market making system operating under an affirmative obligation. The NYSE needs to put aside its "study" of

normal market declines, take a reality pill, and revisit its experience with the 1987 market crash. On October 19, 1987, on trading volume of just over 600 million shares (barely a hiccup in the normal declines the NYSE studied), the NYSE specialist system lost more than half its buying power. The reason is simple: the affirmative obligation and the transformed trading dynamic.

The only way that the NYSE specialist system can survive a crash market is to pre-position the system financially to be able to cope realistically with the extraordinary demands that will be placed upon it.

## 2. Specialist "Buying Power"

The NYSE suggests (page 4) that I "have seriously confused or else disregarded the distinction between a specialist firm's capitalisation and its buying power." Apparently, the NYSE makes this observation because I had used the term "net liquid assets" to underscore the ratio analysis I provided in my January 13, 2006 comment letter.

Let me assure the NYSE that I am neither confused about, nor have I disregard, the distinction between capitalisation and buying power. I used the term "net liquid assets" simply because that is the term the NYSE itself used in its proposal. I am just as happy to use the NYSE's buying power figures, as they do not really change the points I am making.

The NYSE's failure to provide in its proposal clearly material financial data (more on this below) makes discussion here somewhat difficult, but I will proceed based on what the NYSE has provided. Specialists enjoy favorable market maker margin treatment, in a ratio of 4 to 1. Thus, as the NYSE points out, its projected \$1.1 billion net liquid assets capitalisation of the specialist system (a 40 percent reduction from the current \$1.8 billion level) results "conservatively" in specialists having \$4.4 billion in buying power.

The NYSE then "fudges" the discussion somewhat, stating that specialists may actually have up to \$7 billion of buying power as a result of industry "financing practices." The NYSE also notes that additional specialist buying power of \$1.2 - \$2 billion "can reasonably be expected." According to the NYSE, this results in "total specialist buying power of \$5.6 - \$9 billion."

The NYSE's discussion of this presumed additional buying power is clearly problematic. To the extent that a "cushion" is available above and beyond the mandated net liquid assets figure, all well and good. But it is curious, to say the least, for a regulator to be positing this as a safeguard that the Commission and the investing public can absolutely rely on. (If the NYSE believes \$9 billion in buying power is desirable, it should simply mandate that figure in its rules).

The NYSE needs to require in its rules that the specialist system be pre-positioned with adequate capital to withstand a crash market. The problem with relying on "additional

capital" that "may be" available is that it will almost certainly not be available in a crash market, when the entire financial system will be under severe stress.

The only prudent course for a regulator to take is to rely on the capitalisation that is mandated to be there, as opposed to capital that may or may not be there, or may or may not become available, when the crunch comes. The Commission and the investing public can only take confidence in the mandated, pre-positioned capitalisation figure.

Thus, the only figure that is really relevant to this discussion is the NYSE's proposal that specialists maintain net liquid assets of \$1.1 billion, with total buying power of \$4.4 billion. This constitutes a reduction from current net liquid assets of \$1.8 billion and current buying power of \$7.2 billion. In other words, the NYSE is proposing to reduce specialist buying power by a whopping \$2.8 billion.

In contrast, as the NYSE notes in footnote 9 of its proposal, the NYSE specialist system had \$2.3 billion in buying power immediately preceding the 1987 crash, a figure that was reduced to \$1.1 billion (less than half) at the close of business on October 19, 2006.

As the NYSE appears to prefer that I discuss this matter in terms of specialist buying power, I shall use those figures in my ratio analysis below.

### 3. The "Changed Profile" of Specialist Organisations

The NYSE observes (page 4 of "response") that the financial profile of specialist organisations today is much different than it was in 1987. According to the NYSE, many current specialist organisations "are part of larger public companies that have a significant capital base that is available to provide both financial support and liquidity to the specialist."

It is undeniable that the profile of the specialist community has changed since 1987. In 1987, there were 55 relatively small specialist organisations; today, there are seven specialist organisations, five of which dominate the landscape. It is also undeniable that, in absolute terms, the specialist system has more capital (\$1.8 billion in net liquid assets today versus \$808 million in pre-crash 1987). But relative to average daily trading volume, the specialist system today is in fact significantly less well-capitalised than in 1987. In 1987, average daily trading volume (ex the crash days) was about 150 million shares per day, against net liquid assets of \$808 million, a specialist capital to trading volume ratio of a little better than 5 to 1. Today, in contrast, average daily trading volume is 1.8 billion shares against net liquid assets of \$1.8 billion, a capital /volume ratio of only 1 to 1. (The net effect is obviously the same if we use buying power figures).

It is also important to remember that risk of financial failure of the specialist system itself was spread over 55 organisations in 1987, whereas that risk is concentrated today in just 7 organisations. Notwithstanding the myths promulgated by the NYSE's marketing machine, it is clear that the NYSE specialist system, in relative terms, is a less well-capitalised business with a higher degree of systemic risk than it was in pre-crash 1987.

The numbers simply speak for themselves, loudly and clearly. In a crash market, the NYSE specialist system as currently capitalised is an accident waiting to happen. And VaR ratios, hedging techniques, etc. will be powerless to stop the carnage.

The notion that NYSE specialist organisations are "part of larger companies" is not only, for the most part, false, it is highly misleading. The NYSE has carefully crafted its rules so that specialist organisations are not "part" of larger companies, but are in fact independent affiliates operating as separate, stand-alone companies. A "parent company" has no legal liability under NYSE rules to contribute so much as a penny to its specialist affiliate during a crash. Would they contribute anyway? Maybe, maybe not. A "parent company" will most likely also find itself under severe financial stress and, given its fiduciary duty to shareholders, may be highly reluctant to "throw good money after bad", or, if it does add capital, it may be nowhere near the amount actually required. A matter such as this is simply too contingent and unknowable to provide the Commission and the investing public with the requisite degree of advance reassurance.

As I noted above, the only capitalisation figure that the Commission and the investing public can look to with confidence is the mandated, pre-positioned amount, an amount which must be prudently calculated to ensure the survival of the NYSE specialist system.

#### 4. Lessons Learned from the 1987 Crash

There is obviously no "objectively perfect" way to predict how much capital specialists will in fact need to withstand a market crash. But the 1987 experience provides a relevant, meaningful "approximate gauge" as to the trading dynamic, volume multiplier, and impact on specialist capital that may be expected.

I presented several ratios in my January 13, 2006 comment letter, an analysis that the NYSE has not refuted. Let me express the matter even more simply, using the "buying power" figures the NYSE seems to prefer. As footnote 9 of the NYSE's proposal indicates, specialist buying power on October 19, 1987 declined from \$2.3 billion to \$1.1 billion, a loss in buying power of \$1.2 billion. Trading volume on October 19, 1987 was about 600 million shares, with a multiplier of 4 over the average daily trading volume of 150 million shares. In effect, the specialist system lost \$2 in buying power for each share that traded.

Bearing in mind the volume multiplier of 4 (which is very conservative today) and the 2 to 1 loss of buying power ratio, it is clear that the NYSE specialist system today could not survive a crash of the magnitude that occurred in 1987. Using the (conservative) multiplier of 4, the NYSE would be faced with crash volume of about 7.2 billion shares for its affirmative obligation-driven specialists to contend with. Under the 2 to 1 loss of buying power ratio, the specialist system would need \$14.4 billion in pre-positioned buying power just to be able to end the day flat broke.



This is nightmare stuff, and not only is the NYSE not paying attention, it has put blinders on in proposing to reduce specialist buying power to a pre-positioned \$4.4 billion. Even the current buying power figure of \$7.2 billion is seriously inadequate.

As guardian of the investing public's interest, the Commission cannot possibly accept even the current state of affairs, much less approve the huge reduction the NYSE is seeking.

### The NYSE Has Omitted Material Information

In my January 13, 2006 comment letter, I noted that the NYSE had failed to disclose the current level of NYSE capitalisation, and had failed to explain the impact of its proposal, which, I noted, should be expressed both as a matter of how many dollars would be taken out of the system, and what the percentage decline would be.

The NYSE's response on this point is baffling. Clearly, "before and after" dollar figures are material per se here. But the NYSE continues to refuse to provide them, suggesting that it has something to hide (which it does: a whopping 40 percent reduction in specialist system capitalisation). Rather, the NYSE simply states that proposed capitalisation levels (no specific detail whatsoever) would remain substantially higher than would otherwise be required under the net capital rule. This is both a curious and disingenuous position for the NYSE to be taking.

The net capital rule is intended to ensure the operational and financial stability of broker-dealers and to ensure a baseline degree of financial responsibility to protect broker-dealer customers. (Specialists do not really have "customers" in this sense). The net capital rule does not focus on, and is not intended to focus on, the unique market making demands imposed upon a specialist operating under a strict affirmative obligation. Specialist capital requirements (as overseen by the NYSE and SEC) have been primarily addressed in rules separate and apart from the net capital rule, and have always imposed requirements far higher than those called for under the net capital rule. There is a good reason for this: the public must be assured that the NYSE's market making system, the engine that drives the primary market, can continue to function during times of severe market stress.

The NYSE also notes that it monitors specialist capital on a daily basis, and will continue to do so. All well and good (the NYSE is simply doing its job), but daily monitoring of capital requirements hardly addresses the issue of whether those requirements are adequate to begin with should a crash occur.

The NYSE maintains (page 2 of its "response") that it drafted its proposal "in the context of contemporary market structure realities." But the NYSE does not specifically note these realities. Presumably, the NYSE is simply referring to the consolidation of

specialist organisations and the purported "excessive" levels of current specialist capitalisation.

The NYSE has, however, ignored the reality it ought to be focusing on, concentrated systemic risk and the explosion of trading volume (about triple) since current capitalisation levels were adopted more than 10 years ago. And yes, there are "economies of scale" when specialist organisations combine, but these are principally of a back office staffing, bulk purchasing, etc. nature. There are no "economies of scale" with respect to market making under the affirmative obligation.

The NYSE strongly disagrees with my claim that its proposal fails to provide a sufficient basis for the proposed capitalisation requirement. But the problem here goes deeper. The issue is not whether the NYSE believes it has a sufficient basis for going forward. Obviously, the NYSE believes this, or it would not have submitted the proposal. The real issue is whether the Commission and potential commentators have the material information they need to come to their own conclusions here.

In the absence of specific "before and after" financial information, the public is "blind" as to the actual impact and ramifications of the proposal, and, in this context, the NYSE's "trust us" approach is ludicrous on a matter of such public importance. The absence of any discussion as to how the specialist system self-insures against financial risk and financial failure "blinds" the public as to the potentially disastrous consequences of a specialist organisation's financial failure in a crash market.

The NYSE's proposal, in its current form, is largely a self-serving "prosecutor's brief", omitting material information necessary for the Commission and the investing public to make a balanced assessment of systemic risk. What is the NYSE really trying to hide?

The NYSE, as a primary market, must be held to a higher standard than this. The NYSE must be directed to amend its Federal Register notice so that all material financial information is presented in a simple, readily comprehensible format. In addition, the NYSE must be made to address the self-insurance/systemic risk factors that led to the current capital requirements being adopted in the first place.

Simple fairness to the Commission and the investing public demands no less with respect to an issue of this magnitude and consequence.

There Is No Marriage "Penalty"

In my January 13, 2006 comment letter, I clearly noted that the NYSE's Specialist Combination Policy requires that, when two specialist organisations merge, the resulting specialist organisation must maintain capital at least equal to the total capitalisation of each pre-merger organisation.

In response, and notwithstanding my clearly expressed understanding of what the Combination Policy provides, the NYSE presented (page 7) a scenario in which two specialist organisations merge (each with excess capital), but are required to maintain that same level of capital post-merger. The NYSE claims that this is a "marriage penalty" and contends that I have denied its existence.

The NYSE has clearly misconstrued my comments. I agree completely with the scenario posited by the NYSE. Indeed, this scenario is clearly and intentionally mandated in the Combination Policy. What I had said was that this is not a "penalty" in the sense of any additional requirement being imposed. All that is happening here is that there is no reduction in specialist system capital, as per the Combination Policy's insistence (in line with the self-insurance concept) that there never be any diminution of specialist system capital when specialist organisations merge or otherwise combine.

This maintenance of systemic capital should not be characterised as a "penalty" for two reasons. First, the combination adds to systemic risk. (I gave an example, which the NYSE did not refute). It is hardly a "penalty" to ask the entities involved in the combination to bear that risk. Second, it would be entirely inappropriate, given the increased systemic risk, to at the same time reduce what is effectively the self-insurance fund.

Specialist organisations may not care for this result. But the NYSE obviously made a very deliberate, and sound, policy decision (concurrent with the SEC in approving it) that this result was entirely in the public interest.

The NYSE's policy decision is still absolutely in the public interest, and the current NYSE staff have made no case whatsoever as to why the NYSE's earlier determination should be overturned.< /DIV>

#### VaR and the NYSE's Risk Management Analysis

The NYSE has suggested that I have disparaged VaR as a risk management tool by referring to it as the "flavour of the month." The NYSE is misconstruing my remarks here. I clearly referred to VaR as an effective day-to-day risk management tool. I was, however, sounding a note of caution, as VaR does not purport to address "event risk", the most likely trigger of a crash market. VaR has obvious limitations as a tool for determining pre-positioned capital requirements sufficient to withstand a crash market. It is simply not intended to be used for such a purpose. The NYSE has not refuted my analysis on this point.

The NYSE (perhaps under prodding from the SEC) needs to make a realistic policy decision as to an appropriate level of specialist capitalisation to make the specialist system as "crash proof" as possible. VaR, notwithstanding its utility as a day-to-day risk

management tool, has little, if any, role to play in the NYSE's making that policy decision.

I will not further discuss the NYSE's "study" of normal market declines. The NYSE has not refuted my analysis of its deficiencies, but has simply reiterated its view that it believes this "study" is relevant. I submit that no independent observer would possibly come to that same conclusion.

### The "Fire Sale" of Specialist Organisations

I fully appreciate that the NYSE cannot discuss this in a public document. But the aggressive specialist lobbying, and the ultimate purpose thereof, are well known "on the street", and I reiterate my earlier comments.

### The "Hybrid Market"

I reiterate my earlier comments. The NYSE's response (essentially that it studies developments and "monitors" capital requirements) is woefully inadequate, particularly in the light of the proposed radical expansion of the specialist's dealer role, and the projected huge increases in trading volume. The NYSE's "monitoring" response (pro forma and make weight) indicates that the NYSE is doing no thinking here whatsoever. It is an untenable proposition by any standard for the NYSE to be proposing to reduce specialist capitalisation when it knows it may be on the cusp of a radical redefinition of its market. A crash while the the NYSE is "monitoring" the situation would be truly catastrophic.

### Conclusion

The capitalisation of the NYSE specialist system is like the levee system in New Orleans before Hurricane Katrina. It is more than adequate for sunny days and even for typical storms, but it will crumble in the face of a serious hurricane.

Everyone knew about the problems with the levees, but everyone deferred action until good fortune ran out. And so it is with the capitalisation of the NYSE specialist system, the failure of which will absolutely devastate U.S. (and possibly world-wide) financial markets. This problem is a ticking time bomb, and the Commission is on formal notice here.

This is ultimately a broad public policy issue, not a net capital rule issue. The answer does not lie in debits, credits, capital charges, haircuts, Basel standards, VaR ratios or the

the like. The answer lies in conscientious regulators taking a clear-eyed look (irrespective of "political" consequences) at the situation and insisting upon a level of specialist capitalisation that is commensurate with the horrendous impact a crash would have on U.S. markets if the NYSE cannot function.

The Commission was clearly of that mindset in post-crash 1987.

The current Commission must adopt that same mindset today.

Sincerely yours,

George Rutherford  
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