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Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-9303

Re: File No. SR-NYSE-2005-38 Relating to Proposed Amendments to NYSE Rules104 ("Dealings by Specialists") and 123 ("Specialist Combination Review Policy")

Dear Ms. Sanow:

On May 26, 2005, the New York Stock Exchange (the "Exchange" or "NYSE"), pursuant to Rule 19b-4[1] under the Securities Exchange Act of 1934[2], submitted to the Securities and Exchange Commission (the "SEC" or "Commission") File No. SR-NYSE-2005-38 (the "Filing"), which proposed several amendments (the "Amendments") to NYSE Rules104 ("Dealings by Specialists") and 123 ("Specialist Combination Review Policy"). On November 22, 2005, the Exchange filed Amendment No. 1 to the Filing, which replaced the original in its entirety. The proposed Amendments are intended to restructure the capital requirements of specialist organizations in light of the consolidation of specialist organizations over the past several years and the Exchange's experience with respect to the evolving market conditions in which specialists operate. The Filing was published for comment in the Federal Register on December 23, 2005.[3]

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[1] See CFR 240.19b-4.

[2] 15 U.S.C 78a et seq.

[3] See Release No. 34-52969 (December 16, 2005) 70 FR 76337 (December 23, 2005) (SR-NYSE-2005-38).

The comment period, which ended January 13, 2006, resulted in one comment letter (the "Comment Letter"), dated January 13, 2006, from Mr. George Rutherfurd (the "Commenter") who identifies himself as a "Consultant" to two unidentified "institutional trading organizations."

The Comment Letter sets forth six areas of concern, each of which is outlined and addressed as follows:

Comment #1 - The NYSE has Omitted Material Information

In the Comment Letter, Mr. Rutherfurd asserts that, while the NYSE proposal states that "$1.1 billion of net liquid assets across all specialist organizations would provide a prudent level of capitalization for normal business operations with sufficient reserve in the event of severe shocks to the market," the proposal neither provides the basis for such assertion, nor explicitly states that the proposal would result in "a very significant reduction in specialist capital requirements." Further, the Commenter states that the proposal "…does not indicate exactly what the current capitalization of the specialist system is" nor "the extent of the proposed reduction." Mr. Rutherfurd asserts that the "impact of the proposal… should be expressed both as a matter of how many dollars would be taken out of the system, and what the percentage decline would amount to." It is recommended that the Exchange "amend its Federal Register notice so that a discussion of all material financial information is presented in a simple, readily comprehensible format."

NYSE Response

The Exchange drafted the proposed Amendments in order to establish comprehensive capitalization requirements that address the specialist system in the context of contemporary market structure realities. As discussed in the Filing, and further addressed in this response to Mr. Rutherfurd's comments, the proposed capitalization levels**,** which remain substantially higher than the requirements of Exchange Act Rule 15c3-1, are more than adequate to meet specialist responsibilities in this regard. The Exchange has, for many years, closely monitored specialists' financial condition pursuant to information received on a daily basis regarding inventory balances and liquidity. The Exchange will continue this close surveillance going forward. Further, for more than two years, the Exchange has been analyzing capital needs and measures of capital adequacy for the specialist community in light of these market realities. While not incorporating the level of detail the Commenter may feel is warranted, the Exchange strongly disagrees that the proposal fails to provide a sufficient basis for the proposed capitalization requirements. Set forth below is a point-by-point response to Mr. Rutherfurd's letter that further addresses this issue as well as the others raised therein.

<u>Comment #2 - The Current Capitalization of the Specialist System Is Seriously Inadequate</u>

Mr. Rutherfurd notes that specialist capital requirements had been raised both in response to "the 1987 market crash" and again "in the context of a post-1987 phenomenon occurring on the NYSE whereby specialist organizations began rapidly merging with one another" (the "Combination Policy"). He further notes that, in response to concerns regarding "a highly concentrated specialist business with its magnified risks of political failure," the Exchange took a "calibrated approach to imposing significant capital requirements with respect to the most actively traded stocks." Mr. Rutherfurd states that the proposed Amendments represent "a substantial dismantling of that financial reassurance."

Mr. Rutherfurd further claims that NYSE's rule submission lacks "any discussion whatsoever of a crucial consideration in the Combination Policy" namely, "the minimization of risk of failure of the specialist system itself." He states that "as specialist organizations have evolved into behemoths under the Combination Policy, the risks of systemic financial failure have become greatly magnified, much more so than in 1987, when the failure of small organizations would not have brought down the system." The Commenter states that since "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…in the event of a crash/severely stressed market, investors need to have confidence that the NYSE's market making function can continue to endure as a whole." The Comment Letter asserts that the Exchange's current levels of capitalization are "clearly inadequate" to withstand a severe market downturn given a specialist system that "self-insures" by responding to the failure of a specialist organization by reassigning that organization's stocks to another specialist organization, "which doubtless will itself be under severe financial stress."

In addition, the Commenter states that "the figures supplied by the NYSE suggest that, in relation to the 1987 crash, the specialist system is, even today (much less under the proposed reduction), not prepared to withstand a "financial earthquake" significantly less severe than the one experienced in 1987. In this regard, "the NYSE notes that, just prior to the 1987 crash, the specialist system had net liquid assets of $808 million. The NYSE website indicates that average daily trading volume in 1987 (excluding the crash week) was about 150 million shares per day." In short, the concern expressed is that "the existing ratio of net liquid assets to average daily trading volume is only 1 to 1, as opposed to 5 to 1 in 1987" when "about two-thirds of the specialist organisations were ether (sic) flat broke or within a whisker of it."

<u>NYSE Response</u>

Mr. Rutherfurd's comparison of volume and capitalization levels fails to take into account the transformation of the competitive landscape in response to the enormous growth in the markets over the past two decades. In stark contrast to 1987, the markets today are comprised of many large and technically sophisticated institutions able to trade securities in volumes unimaginable twenty years ago.

With respect to the analysis presented, the Commenter bases his contentions on incorrect presumptions and fallacious logic. Specifically, the conclusions the Commenter extrapolates from a comparison between the "Volume to Net Liquid Assets Ratio" in 1987 and current Volume to Net Liquid Assets Ratio are flawed. Contrary to Mr. Rutherfurt's suggestion, there is no longer a direct correlation between the level of daily trading volume and the amount of specialist capital required. To the contrary, the increase in the level of average daily trading volume in today's market is indicative of greater liquidity and thus greater stability and resiliency, as well as greater opportunities for the specialist to hedge or liquidate positions.

Further, the Commenter appears to have seriously confused or else disregarded the distinction between a specialist firm's capitalization and its buying power.
Specialist capitalization is the level of liquid assets that the specialist organization has available to support its affirmative obligation of maintaining fair and orderly markets. Buying power, on the other hand, reflects the inherent leverage available to the specialist community when utilizing its capital to buy and sell positions. This leverage exists due to the financing and margining systems available in the marketplace today. As a result of this leverage, specialist firms are able to purchase positions far in excess of stated capital, should the need arise. This additional capacity is created by their ability to borrow money from banks or clearing broker-dealers, utilizing their specialist positions as collateral, and can result in obtaining financing in excess of 600%.

There seems to be additional confusion on Mr. Rutherfurd's part regarding the significant regulatory differences between "net capital" and "net liquid assets" with respect to their potential impact on specialist financial integrity in the event of a market decline. In this regard, "net capital" is a conservatively designed regulatory measure of the prudent level of liquid assets required of a broker-dealer. In contrast, the term "net liquid assets" refers to liquidity in the form of cash and cash equivalents that is immediately available to a specialist organization for the purchase and sale of securities in which such specialist is registered, in support of its specialist book, and market maintenance obligations. It is a shorter-term form of liquidity that is meant to be available to the specialist organization pursuant to its ongoing obligation to maintain a fair and orderly market on the Exchange. Thus, a net liquid asset requirement functions to ensure that the specialist continues to operate; whereas a broker-dealer's net capital requirement functions to ensure that, if the broker-dealer were liquidated, the broker-dealer's obligations to its customers and creditors would be satisfied. The former is a market-oriented measure of immediate liquidity; the latter is an SEC measure of regulatory capital.

It is important, as well, to recognize that the financial profile of the specialist today is much different than it was in 1987. Many of today's specialists 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. Further, in today's world, with much larger specialist firms who maintain much higher capitalization levels than those required in the past, actual buying power exceeds even the most conservative estimates of future expected needs. In this regard, the estimated $1.1 billion of required specialist capital under the proposed rules would conservatively provide specialists with $4.4 billion of buying power and, more realistically, up to $7 billion of buying power as a result of industry margining and financing practices.

In addition, based upon historical levels of excess net liquid assets maintained by specialist firms, additional specialist buying power of $1.2 - $2.0 billion can be reasonably expected. This results in total specialist buying power of $5.6 - $9.0 billion. A study of the market has shown that in a worst-case market scenario involving a 30% straight down market decline (with no zig-zags), specialists could be called upon to purchase positions approximating $2.25 billion which is between one quarter and two fifths of expected buying power under the proposed Amendments. In fact, even if the Exchange's projections proved too conservative, as the Commenter claims, and specialists were required to assume positions twice as large ($4.5 billion) the specialist system could still readily absorb these positions under the proposed Amendments.

Comment #3 - The NYSE's "Risk Management" Analysis is Flawed and is Irrelevant to a Crash Market

Mr. Rutherfurd questions the proposal's utilization of VaR ("Value at Risk") "as a basis for supplementing basic capital requirements," referring to it as the "'flavour of the month' with respect to the securities industry's quest for its Holy Grail, a risk management tool that actually works." He states that "while certainly useful for internal, day-to-day management purposes, [it] is irrelevant to specialist market making activities during a crash market, or for pre-positioning specialist organizations from a capital requirements standpoint prior to a crash" because it does not address 'event risk' (e.g., a crash/severely stressed market based on events rather than historical trading models and relationships among trading instruments)."

Similarly, according to Mr. Rutherfurd, "the NYSE's 'worst case' market scenario reasoning is similarly flawed in the most fundamental sense. The NYSE has analyzed market declines over a six-year period (1998-2004) and determined that, on average, specialists purchase $75 million in stock for each 1 percent market decline." The commenter takes issue with the NYSE position that "based on this 1 percent/$75 million 'evidence', the specialist system would be adequately capitalized, even under the proposed reduction, if the market were to experience a straight 30 percent decline (the point at which the "circuit breaker" shuts down the market)."

NYSE Response

With respect to the issue of risk-management generally, NYSE Rule 104 does not currently incorporate any risk-based component. Thus, specialists are not now penalized for carrying positions that "eat up" capacity. For example, the specialist requirement for a common stock is currently $500 thousand regardless of the number of shares the specialist has in inventory (be it one share or one million shares). Under the proposed rule, specialist capital requirements will increase as un-hedged inventory levels increase.

With respect to Mr. Rutherfurd's comments on the VaR model specifically, VaR is a generally accepted method of measuring risk for financial organizations. In fact VaR is one of the more generally recognized and effective risk measurement tools employed by the financial services industry and increasingly by the Securities and Exchange Commission - particularly with respect to larger organizations such as Consolidated Supervised Entities ("CSE"),[4] whose financial impact upon the market is significant. Contrary to Mr. Rutherfurd's remarks, VaR as a risk measure certainly does not fall into the "flavour of the month" category. In fact, it is the defined measure for managing day-to-day activity as set forth in the Basel II standards and as such the Exchange anticipates that it will provide appropriate day-to-day risk management for its specialist firms. The regulatory community has relied upon VaR for a decade and, thus, is in a position to assess VaR computations in an objective, informed manner.

However, the Exchange is also fully aware of the limitations of VaR; for example, that it does not measure the tail risks that occur when a market is under extreme stress. It is precisely for this reason that the Exchange is proposing a basic specialist capital requirement of $1 million for each .1% of specialist transaction dollar volume that will provide a cushion of $1 billion for exceptionally adverse events. With respect to day-to-day risk management, the Exchange is proposing three times VaR as the capital charge (which is consistent with SEA Rule 15c3-1).

Comment #4 - There Is No "Marriage Penalty"

The Commenter, while acknowledging the "economies of scale" benefits that result when specialist organizations merge, contends that "…there is no "marriage penalty" imposed in the sense of any additional requirement being added" and that "[t]he Combination Policy simply (and thankfully) precludes any reduction in the overall capitalization of the specialist system, in line with the Policy's emphasis on minimizing systemic risk…"

Further, according to Mr. Rutherfurd, despite the "economies of scale" benefits, "the Combination Policy has also recognized increased systemic risk of catastrophic financial failure as a result of the specialist business becoming so highly concentrated. The failure of a large newly-merged specialist organization would place a much greater strain on the capitalization of the specialist system than the failure, separately, of either of the organizations involved in the merger."

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[4] See Exchange Act Rule 15c3-1(c)(15) which, as part of the SEC's Consolidated Supervised Entity ("CSE") rules, establishes a voluntary method of computing net capital for large broker-dealers that are part of a CSE. Eligibility to use the alternative/CSE method is conditioned upon a broker-dealer's compliance with several requirements, including comprehensive internal risk management procedures that address the firm's market, credit, liquidity and operations risk.

NYSE Response

The "marriage penalty" that exists under current NYSE Rule 123E(f)(i) automatically requires a higher capital requirement when specialist organizations merge, rather than allowing for a prudent evaluation of capital requirements in line with the newly combined specialist organization's market risk. 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. However, the current capital requirement does not recognize the benefits derived from such consolidation. The proposed Amendments address the Exchange's view that the current net liquid asset requirement for such specialist organizations is based neither upon the amount of risk a specialist organization is taking nor upon the dollar value or volatility of its portfolio.
The Commenter's contention that there is currently no "marriage penalty" is simply inaccurate. For example, assuming that Specialist Firm A with a capital requirement of $90 million and excess capital of $25 million announced its plans to merge with Specialist Firm B which has a requirement of $70 million and excess capital of $20 million. Under the Exchange's current specialist capital rules, newly merged specialist Firm C would have a capital requirement of $205 million, not $160 million. This 28 % increase in minimum capital requirements under the Exchange's current rules is the Marriage Penalty that Mr. Rutherfurd claims not to exist.

Comment #5 - Any Consideration of Reduced Specialist Capital Requirements Is Premature in Light of the NYSE's Pending "Hybrid Market" Proposal

Mr. Rutherfurd states that "[c]ommon sense dictates that the NYSE and the SEC need several years experience with the actual "hybrid market" before making a prudent assessment of appropriate specialist system capitalization."

NYSE Response

Any withdrawals of additional excess net liquid assets resulting from the amended specialist capital requirements will be gradually phased in, on a measured basis, over a nine-month period to allow for an orderly and carefully considered transition. Further, consistent with its duties as a self-regulatory organization, the Exchange as a matter of policy considers the impact of other rules, policies, procedures, systems, etc., in promulgating changes to its rules. Accordingly, the Exchange will, on an ongoing basis, continue to consider the impact of the proposal on specialists and capital requirements in light of any potential ramifications related to the Hybrid Market in this regard. Also, as noted above, the Exchange will continue to monitor specialists' financial condition, on a daily basis, in view of data relating to inventory balances and liquidity.

Comment #6 - The SEC Should not Reduce Capital Requirements to Facilitate a "Fire Sale" of Specialist Organizations

Mr. Rutherfurd contends that an underlying purpose of the proposed Amendments is to make it easier for existing specialist organizations to sell their businesses to potential buyers who would be "attracted by reduced capital requirements."

NYSE Response

The Exchange is not aware of any information that would lend credibility to the Commenter's contention. To the contrary, modernized, market-based specialist capital requirements may have the effect of attracting new specialist firms into the marketplace.

Questions concerning this letter may be directed to Grace B. Vogel, Executive Vice President - Member Firm Regulation, at 212-656-2947.

Sincerely,

Mary Yeager

Mary Yeager
Acting Corporate Secretary