December 13, 2005

Dear SEC:

I am writing with regard to the above-referenced rule submission, which cannot possibly be approved by the Commission.

The NYSE is attempting the "temporary" implementation of a number of highly controversial rules, rules which have been the subject of substantial, substantive criticism, to which the NYSE has been unable to respond.

To allow the NYSE to implement these rules, pursuant to a purported "pilot program", before the Commission has reached a final determination as to whether these rules are, in fact, in the public interest, is tantamount to allowing the NYSE to front-run and circumvent the Commission's normal rule approval process. Furthermore, it would be an absolute insult to those commentators who have raised serious issues with the proposal for the Commission to allow the rules to be implemented, even in temporary form, before the Commission has weighed in on all issues and articulated its reasons for whatever action it ultimately determines to take.

SR-NYSE-2005-87 displays the NYSE's usual mastery of the "form" of a rule submission, but, sadly typical, the submission is totally lacking real intellectual content. It is a mass of technical gobbledygook, virtually impenetrable to an outside observer.
As with the other "hybrid market" rule submissions, it consists only of simple exposition, with only the vaguest of pro forma representations as to how any of this in the public interest, as opposed to the the interest of NYSE floor brokers and specialists.

Even on its own terms, the NYSE has not demonstrated any need for the proposal.

Simply put, the NYSE "pilot program" confers new and significant advantages to NYSE floor brokers and specialis ts at the expense of the public limit order book. By any legal standard, the proposal is clearly not in the public interest.

The Purported "Need" for the "Pilot Program"

The NYSE represents (page 4) the following as the reason why the "pilot program" is needed:

"The Pilot will allow the Exchange to conduct real-time system and user testing of certain features of the Hybrid Market proposals in order to comply with the implementation of Regulation NMS."

The NYSE also represents (page 4) the following:

"The ability to have such real time user interface will be invaluable, as it is impossible to accurately anticipate behavioral changes in a development or mock-trading environment. In addition, the Pilot will al low users to gain essential practical experience with the new systems and processes in a well-modulated way."

First, let me state the obvious. None of this is "required" by Regulation NMS. In fact, many aspects of the "hybrid market" initiative are completely at odds with the underlying spirit and philosophy of Regulation NMS, which is the protection of public limit orders. We all know that "something has to give" on the NYSE with the implementation of Regulation NMS. But what "gives" should not be the public limit order book, but rather the unique privileges enjoyed by the NYSE's uniquely-situated floor intermediaries.

As I have demonstrated in my comments on SR-NYSE-2004-05 and its various amendments, the essence of the "hybrid market" is a system of three competing limit order books: the public limit order book, a limit order book consisting of floor broker "go along" ("parity") orders (disingen uously referred to by the NYSE as "floor broker agency interest files"), and a limit order book consisting of the specialist's proprietary limit orders. This system of competing limit order books has nothing to do with Regulation NMS, but is rather a vehicle to ensure that, in the first instance, the floor broker orders get to enjoy electronic executions in a manner that seriously disadvantages the public limit order book, and, in the second instance, ensures that the specialist's dealer account gets to enjoy electronic executions in direct competition with public orders represented by floor brokers, thereby degrading the quality of executions that those orders are otherwise entitled to.

I and other commentators have raised serious concerns with this, and the NYSE has studiously avoided, and continues to avoid, any discussion whatsoever of the impact of its "hybrid market" on the public limit order book. The NYSE's September 21, 2005 attempt at "respo nding" to criticisms of the "hybrid market" proposal is singularly embarrassing in this regard.

The Exchange states (page 5) that it expects "minimal problems" during the "pilot program", which suggests there is no need whatsoever for the proposal from a systems-testing standpoint (not that the proposed damage to the public limit book could be justified on the ground of "system testing" anyway). No, the real purpose of the "pilot program" is the NYSE's statement (quoted above) regarding "behavioral changes" to be introduced in a "well modulated way." The English translation of this is simple: the "pilot program" will give brokers and specialists experience in fine-tuning their ability to enter electronic orders that will disadvantage public orders on the public limit order book.

It is as though the "pilot program" is a laboratory experiment, and the public limit order book is the guinea pig.

Clearly, there will be real harm here to the public limit order book in the "pilot" stocks.

It really is that simple.

The Problem of "Go Along" Orders

One is thankful that the NYSE is not proposing to implement in the pilot one of the truly egregious features of the "hybrid market" proposal, the proposed sweep methodology. One notes, as well, that the NYSE is also refusing to implement the one feature of the proposal most eagerly demanded by its institutional customers, the removal of order size entry constraints in the Direct system. But why listen to actual customers when the real task is to appease the trading floor constituency?

But the proposal is still highly noxious with respect to go along orders, because these orders are entered with knowledge of the public orders on the public limit order book, but the limit order book customers have no knowledge of the go along orders that are competing with them for executions. This gives two huge, and patently unfair, advantage to the go along orders. First, the public limit order customers have no opportunity to adjust their limits and more fairly compete with the go along orders. Second, when the away from the market go along orders become part of the displayed quotation, they instantly trade on "parity" with the public limit order book, even though the public limit orders may have clear time priority. (See my correspondence on SR-NYSE-2004-05 for a complete discussion of why go along orders, with the outmoded "parity" concept, seriously disadvantage the public limit order book in very specific ways). This is a huge, and unfair, change from the way the market works today. NYSE autoquote would give the public limit order book clear priority in the auction, with brokers being able to bid their go along orders only after autoquote had changed the quote .

The only fair outcome, and one consistent with the philosophy of Regulation NMS, is to give the public limit order book clear price/time execution priority. The floor brokers should be permitted to enter electronic go along orders, but they should be executed only after the orders on the public limit order book at that price have been executed.

Specialist Trading

Again, one is thankful that the NYSE is not proposing to implement in the "pilot program" the most outrageous feature of the "hybrid market", the proposed "algorithmic" trading. (An NYSE specialist confirmed to me that this is feature is a direct result of specialist lobbying for increased dealer account trading opportunities).

But what the NYSE is proposing to implement is only slightly less outrageous. The NYSE is proposing to permit specialists to "layer the book" (English translati on: enter proprietary limit orders on a hidden limit order book) to trade electronically with incoming order flow. Specialists would get to enter these orders with knowledge of the publicly disclosed public limit order book, but also with knowledge, which they and they alone have, of the go along orders, which are hidden to the rest of the world, but which are disclosed to the specialist. In other words, the specialist gets to engage in automated insider trading, because the specialist, with exclusive, non-public but highly material knowledge of the hidden go along orders, gets to enter his/her own dealer orders in relation to where the hidden orders reside on the go along limit order book. Nice work if you can get it! And neither the public limit order book customers, nor the floor brokers, have an opportunity to adjust their limits in response to this hidden competition from the specialist.

It would not be possible to make this stuff up , but that is exactly what the NYSE is proposing. Outrageous seems far too mild a term.

And then there is the proposed ability of the specialist to trade on "parity" with the go along orders. The English translation is simple: the specialist gets to enter hidden dealer account orders that compete directly with the public go along orders and thereby degrade the quality of executions otherwise available to those orders. I have commented extensively on why this is inherently objectionable, totally inconsistent with the negative obligation, etc. (See my comments on SR-NYSE-2004-05 and its various amendments, as well as my December 12, 2005 comment on SR-NYSE-2005-74). The NYSE is attempting, in as bogus a sleight of hand as I have seen in any document submitted to the Commission, to "put over" on the Commission a recently-invented "longstanding interpretation" of Rule 108 to permit this practice, but has not substantiated it at all. I have every con fidence the Commission will reject out of hand what the NYSE is attempting to do here.

I will note a particularly egregious hypocrisy of the NYSE here. In SR-NYSE-2005-74, the NYSE posits the notion that a "floor broker objection mechanism" is a meaningful protection against specialist overreaching when specialists attempt to compete directly with floor broker public go along orders. In SR-NYSE-2005-87, the NYSE has dispensed entirely with the objection mechanism, leaving the floor broker no recourse other than to have his customer treated as a "second class citizen" (no electronic go along order) if the floor broker wants to object. The real answer here is no specialist parity, but if an objection mechanism were to have any viability anywhere, it would be in an electronic market, where the floor broker is not subject to the NYSE infamous "get along by going along" trading crowd culture, and is "culturally" forced to permit the specialist to compete directly against his/her customer.

The NYSE's hypocrisy here is galling, and can only be explained as a craven accommodation to specialist self-interest.

Automated Execution of Stop and CAP-DI Orders and the Utter Debacle of SR-NYSE-2005-57

In SR-NYSE-2005-57, the NYSE obtained immediate effectiveness of a purported set of "systems enhancements" regarding the automated execution of elected stop and CAP-DI orders. The NYSE represented in that rule submission that "The rules regarding the election and execution of CAP-DI and stop orders...remain the same."

I commented that this was clearly a misrepresentation, as both stop and CAP-DI orders are required to be exposed to the auction for price improvement, and that therefore the NYSE was not simply proposing a "systems enhancement", but was actually proposing a substantive rule change that rendered the pro posal ineligible for immediate effectiveness. The NYSE attempt a "clarification" in SR-NYSE-2005-69, a submission so intellectually-challenged that the NYSE withdrew it within days.

On page 9 of SR-NYSE-2005-87, the NYSE makes the following statement:

"In connection with the Pilot, the Exchange is proposing changes to Rule 76 to clarify that elected stop and stop limit orders are exempt from the requirement that a member expose the order for possible price improvement before crossing it."

This is breathtaking stuff, because what the NYSE is admitting here, de facto, is that it is proposing a material change to stop order executions, despite having denied this in SR-NYSE-2005-57. In other words, the NYSE's "immediate effectiveness" of SR-NYSE-2005-57 was obtained in error, another in a lengthening list of embarrassing mist akes the NYSE staff are making with their own rules. And, as I demonstrated in very specific detail in my October 11, 2005 comment letter on SR-NYSE-2005-57, the NYSE staff are similarly mistaken in their assertion that CAP-DI orders do not have to exposed to the market for price improvement. (I have specifically confirmed this point with both an NYSE floor broker and an NYSE specialist).

This is not simply a "technical" matter. Without properly discussing the issue (the representation I quoted above hardly qualifies), or submitting the matter appropriately under the Commission's normal prior public comment process, the NYSE is taking elected stop and CAP-DI orders out of the physical auction and denying them the opportunity for price improvement. (It is the NYSE's prerogative to propose this, but not in the manner in which it has proceeded). Actions such as this (as well as other aspects of the "hybrid market" proposal), make a mockery of the NYSE 's marketing claim that the benefits of the auction market continue as ever thus in the "hybrid market". In reality, the physical auction is virtually meaningless in the "hybrid market." as its benefits are being legislated out of existence. The SEC simply cannot allow the NYSE to continue to make what is clearly a false and thereby deceptive claim on this.

Given the manner in which the NYSE has proceeded, this aspect of the "pilot program" is singularly inappropriate. Taking elected stop and CAP-DI orders out of the physical auction means a potential "price improvement loss" to public customers ranging potentially into the millions of dollars. (And yes, these orders do in fact receive price improvement currently, a fact confirmed to me by an NYSE floor broker and an NYSE specialist). The public needs to have this issue fairly laid out and exposed for prior public comment. Implementing rules are buried as "technical addenda" in Amen dment 7 to SR-NYSE-2004-05, and are not fairly discussed. In the event, the Commission has not even published Amendment 7 for public comment, much less Amendment 6, and the Commission must do so before it can take any action on SR-NYSE-2004-05.

Conclusion

The SEC cannot possibly approve so inherently problematic a "pilot program." The Commission has made no determination with respect to the underlying concepts, and the SEC staff understand full well that the specific details of the "hybrid market" are in many particulars not at all related to, and are in fact inconsistent with, Regulation NMS.

If the Commission is somehow inclined to approve the "pilot program", it cannot simply issue the NYSE's proposed, self serving "approval order", but must issue its own, and must weigh in in very specific detail as to all the serious underlying issues here.

This is ha rdly a typical "pilot program" in which an SRO works out systems "kinks."

There will be real harm to public limit orders here.

(If the NYSE attempts a response via comment letter, the SEC should publish it promply on its website, under this file number, as the NYSE does not publish its comment letters on its website).

Sincerely yours,

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