November 14, 2006

Dear SEC:

I am writing with regard to the NYSE's attempted response to my October 20, 2006 letter commenting on the above-referenced rule submission. (I note that the SEC website incorrectly lists my October 26, 2006 letter as also having been submitted on October 20. I previously had asked for a correction on this, which was made. But the correction was subsequently undone, and the incorrect date is now again listed. This is hardly a "substantive" matter, but the sloppiness involved is symptomatic of the more serious lack of attention being paid to more substantive "hybrid"
matters).

I would like to note preliminarily that the SEC staff should not, as they did with my rebuttal letter on 2006-36, simply stuff my critique into a handful of superficial footnotes as they non-analytically defer to the NYSE's unsupported, and unsupportable, positions. Rather, this letter should be deemed to be an integral part of my October 20, 2006 comment letter.

I use the term "attempted response" to describe the NYSE's letter, which follows a familiar pattern, although this particular letter falls well below even the NYSE's usual dismal standard. Par for the course, and apparently acting only in response to an SEC staff demand that it remove its head from the sand, the NYSE simply reiterates several of its original positions r cntradicts itself without acknowledgement, ignores most of the most significant criticisms, reduces those criticisms to which it deigns to respond to meaningless caricature, and then proceeds to attack the "straw man" it has so artlessly created. While one has become used to this sort of NYSE "work product" in connection with "hybrid" matters, one must note that the NYSE has stepped way too far over the line here.
As demonstrated in specific detail below, pages 8 through 11 of the NYSE letter in particular are riddled with affirmative misrepresentations that suggest, at best, that the author of the letter has no familiarity with "hybrid" in general and the instant proposal in particular, or, at worst, suggest a fundamental intellectual dishonesty on the part of the NYSE.

And the absolute "kicker", as demonstrated below, is that the principal NYSE "argument" in support of its position in reality proves exactly the opposite and supports my position entirely.

The Procedural Abomination

One of the saddest aspects of the "hybrid" roll-out has been the trashing of the SEC's (formerly) well-respected rule approval process. The SEC staff, acting under "delegated authority" and without the imprimatur of the Commission itself, have been giving immediate effectiveness to matters that, in fact, raise serious, substantive issues. The public are this denied an opportunity for prior comment, and are reduced to the submission of relatively meaningless post-approval commentary. I have commented in other letters how the SEC staff do not analyse public comments and weigh them against NYSE statements, but rather (and not always accurately or completely) simply note comments and then uncritically accept the NYSE's self-serving assertions, even when the inadequacy of those assertions has been amply demonstrated. In every "hybrid" approval order, there has been a singular gap in the "logic" used by the SEC staff: there is never any discussion whatsoever as to "why" anything that is being approved is in the public interest.

The approval order for 2004-05, the basic "hybrid" proposal, though issued by the Commission, is a major intellectual and legal embarrassment. As demonstrated in my March 27, 2006 comment letter, the Commission essentially ducked every major issue raised by commentators, defaulting to meaningless conclusory assertions rather than trenchant legal analysis on each key point. Yet this grossly inadequate, defective-as-a-matter-of-law approval order is treated as "sacred scripture" by both the SEC and NYSE staffs, who continue to use it as "cover" for refusing to deal with fundamental legal issues.

One fundamental legal issue absolutely will not go away: the application of Section 11A of the Securities Exchange Act, which by its plain terms is inconsistent with critical aspects of the NYSE's proposal. As noted in my October 20, 2006 letter, both the Commission and the SEC staff have, to date, flatly ignored the law here in what can only be called a surprising dereliction of duty. Regardless of what the Commission thought it was approving in 2004-05 (an approval based on SEC staff "work product" that manifestly failed to flesh-out the relevant issues), clear, unambiguous black letter law obviously takes precedence over what is surely the least impressive approval order ever issued by the Commission.

The instant matter can only be described as a procedural abomination with respect to a matter of overriding public interest. The NYSE proposal involves the de facto rescission of the negative obligation and the specialist's mandate to stabilise the market.
There is no more fundamental issue than that raised here: to what extent should a monopoly dealer in a primary market be permitted to interfere/compete with public order interaction and execution? As electronic trading proliferates on the NYSE, it is clear to most market participants that the effectuation of the purposes of Section 11A requires, if anything, a strengthening of the negative obligation rather than its virtual elimination, as the minimisatin of dealer participatin is to be expected as a matter of course.

The rules and interpretations at issue herein have always been considered the most important of all specialist regulations, and the instant matter is easily the most important of all the rule changes proposed by the NYSE in conjunction with the "hybrid" market. But the manner in which this critical subject is being treated, a subject that goes to the very essence of how a "fair" market should operate, makes a mockery of the SEC's rule approval process.

As originally submitted on September 22, 2006, 2006-76 contained a proposal that, in practical effect, would largely eliminate specialist stabilisation requirements,particularly in active stocks that constitute most of the trading activity on the NYSE. This is, in essence,an abandonment of the specialist's historic mandate to act only when stabilising the market. The rule submission, a typical NYSE "hybrid" work product, can fairly be described as a jargon-encrusted mess, virtually impossible to readily comprehend. The SEC staff are subject to "plain English" requirements, but they either lack the authority or the guts to impose such requirements on SROs, a huge impediment to the public comment process). And, in the NYSE's usual fashion, the submission contained no discussion whatsoever of the practical effect of the proposal. 2006-76 has been published for prior public comment, but (as discussed below) only with the stabilisation proposal.

On October 5, 2006, the NYSE submitted 2006-82, which was given accelerated (immediate) effectiveness by the SEC staff with no opportunity for prior public comment. This gave "temporary" approval, until October 31, 2006, of 2006-76 and 2006-65, another problematic NYSE proposal. The temporary approval, an obvious sign that the NYSE, not the SEC, is driving the rule approval process, was intended to facilitate NYSE "implementation schedules."

Slipped into 2006-82, and presented as though it were a nagging administrative detail, was an NYSE proposal that, in practical effect, would largely eliminate the negative obligation by "re-interpreting" one of the SEC's oldest rules. Although the NYSE proposal directly impacted the application of the Commission's own Rule 11b-1, the SEC staff simply acted on their own here with respect to a matter that, when properly considered (unlike the NYSE's apparent attempt to "pull a fast one"), effectively neuters the most important tenet of all specialist regulation. Make no mistake: the NYSE's proposed de facto rescission of the negative obligation is fundamentally more significant than any other proposed rule change in the entire NYSE "hybrid" proposal.

Subsequently, and again with no opportunity for prior public comment, the SEC staff approved 2006-96, which extended the "temporary approval" until November 30, 2006. In the interim, the NYSE submitted an amendment to 2006-76 that simply restated the very brief, superficial discussion of the negative obligation contained in 2006-82. To date, the SEC has not re-published amended 2007-76, with the negative obligation material, for prior public comment.

So this is where matters stand: the most significant of all the "hybrid" rule changes was effectively buried in a rule submission which the SEC staff approved on their own (a "temporary" approval, but once such approval is given, permanency is typically treated as an administrative formality) with no opportunity for prior public comment. And the NYSE could not even be bothered to propose an amendment to the text of the negative obligation itself, proceeding instead by way of a brief, superficial discussion of a proposed "re-interpretation" that is flatly inconsistent with, and cannot be derived from, rule text. And the "re-interpretation" focuses not simply on an NYSE rule, but on one of the oldest and most important rules of the Commission itself.

The actions of the SEC staff in many of the "hybrid" approval orders have been inexplicable, but the instant matter is truly unfathomable. While I am sure this is not a matter of conscious intention, the SEC staff's actions nonetheless display a contempt for the investing public and the Commission's own processes.

The root of the problem is this: the SEC staff have been non-analytically accepting the NYSE's inflated representations at face value, an approach that well serves the NYSE, but ill serves the investment community. Whether because of ignorance or simple naivete, the SEC staff display little comprehension whatsoever of the practical, real world effects of many NYSE proposals, effects which make a mockery of the NYSE's self-serving assertions.

It is well past time for the SEC staff to wake up and start understanding the actual marketplace consequences of what they have been content to treat merely as matters requiring routine administrative processing.

It is clear that the instant proposal should be rejected out of hand. But if the SEC staff determine to proceed with additional deliberation, they must act to ensure that the Commission's rule approval processes are administered with integrity. Toward that end, the SEC staff must insist upon the following:

(1) The NYSE must be made to submit an appropriate amendment to the text of the negative obligation itself, rather than proceed by means of a rule text-inconsistent "reinterpretation" slipped into an "implementation schedule" rule submission.

(2) The NYSE must be made to present this rule amendment in plain English, and discuss, in plain English, the impact and practical consequences of its proposal on public order execution.

(3) The NYSE must be made to present a detailed legal analysis as to how its proposal is consistent with Section 11A, which by its plain terms is intended to minimise dealer intervention with public order execution.

(4) The matter must be published for prior public comment. And as this matter involves a radical change in the application of a longstanding, fundamental SEC rule, the Commission must issue its own release seeking public comment on any "reinterpretation" of Rule 11b-1.

At the conclusion of the public comment period, a matter of this consequence should be considered at an open meeting of the Commission. In the unlikely event the Commission determines to issue some sort of approval order, such order must contain a detailed analysis of all relevant legal issues.

The "Straw Man"

On page 4 of its letter, the NYSE suggests that I am a veritable icon of reaction. In the NYSE's view, I am simply arguing that a regulatory framework that was established seventy years ago should never be changed, notwithstanding what the NYSE sees as substantial changes in the way that trading is conducted. The NYSE reduces my position to one that posits that "the clock stopped in 1975." The NYSE even quotes (entirely out of context) my observation that "if there was no need for the Commission to act in 1975 [with respect to possible rulemaking action regarding SEC Rule 11b-1] surely there is no need for such action today."

The NYSE statements are entirely disingenuous, and represent both a most unprofessional distortion of my comments, and a refusal to deal with the substance of what I actually said.

First, let me state what is obvious to anyone with even a passing familiarity with my October 20, 2006 comment letter and my various other comment letters: I have fully supported the NYSE's evolution to electronic trading, which the NYSE itself has readily acknowledged in other correspondence and which the Commission itself acknowledged in its approval order for 2004-05.

My consistent objection has been regarding an issue that is as relevant in 2006 as it was in 1975 and 1934, namely the degree to which trading floor intermediaries should be given anti-competitive advantages over the investing public in the guise of "automating" the NYSE market.

So here's my position, and I'll state it as simply as possible so that even the NYSE will understand it:
automation is good, anti-competitive trading advantages are bad. This is hardly a reactionary position. In fact, it ought to be the position of both the SEC and the NYSE.

My October 20, 2006 comment letter referred to 1975 because the NYSE attempted to use an excerpt from the legislative history of the 1975 Amendments to the 1934 Act to support its position. This excerpt noted two factors that might warrant removing or reducing specialist trading restrictions: active competition among market makers, and the elimination of specialists' trading advantages.

It would be far more accurate to characterise my position as being that the clock started in 1975 rather than that it stopped, particularly when one considers the enactment of Section 11A and its emphasis on minimising dealer intervention. As the wording of the excerpt makes clear, both factors noted above need to be present. In fact, neither one is, when one projects forward from 1975 to 2006. As I pointed out in my October 20, 2006 comment letter, the NYSE today is actually in a much stronger competitive position today than it was in 1975. At that time, specialists faced intense competition from the third market, NYSE market share was much lower than today, and specialist trading opportunities (against much lower volume) were a fraction of what they are currently relative to today's volume.

The NYSE notes that specialists face competition today, but fails to acknowledge that such competition is in fact less intense than in 1975. The NYSE needs to show, but it cannot, that the NYSE's competitive position is in fact weaker today than in 1975, such that the Commission ought to consider acting on Congress' grant of authority. The NYSE's comment letter is conspicuously silent on this point.

The NYSE similarly fails to deal appropriately with the second point, the "elimination" of specialist trading advantages. In its rule submission, the NYSE made the ludicrous claim that specialist trading advantages essentially disappeared in the "hybrid" market. In my October 20, 2006 comment letter, I demonstrated in detail that specialists were in fact being given trading advantages in cyberspace far greater than any they ever enjoyed in the physical auction.

In its comment letter, the NYSE has been forced to acknowledge that specialists do in fact have trading advantages in the "hybrid" market (so much for meeting the Congressional standard that the advantages be eliminated!), but seeks to minimise them. As I demonstrate in specific detail below, the NYSE has affirmatively misrepresented the significant degree to which specialists enjoy these advantages in the "hybrid" market.

The out-of-context quotation from my October 20, 2006 comment letter that the NYSE presented about the absence of Commission action in 1975 had nothing to do with, as the NYSE suggests, whether there have been "material changes" in the marketplace since 1975. It is an obvious, and meaningless, truism to say that there have been. I was making a different, and more fundamental, point about the Commission's response to Congressional intent, and it is a point worth repeating. In 1975, the Commission was given authority to transform the negative obligation, provided such action was warranted by a change in the competitive landscape and the elimination of specialist trading privileges, not simply by technological changes in the way trading is conducted. Yet, even when the NYSE's competitive position, and specialist trading opportunities were much more adverse than they are today, the Commission (wisely) declined to act.

Why should the Commission then act today, when the NYSE's competitive position is much stronger, and even the NYSE itself has had to concede that specialist trading advantages have most certainly not been eliminated?

Clearly, the NYSE has not, and cannot, meet its burden of proof here.

The "Exceptionalist" Approach to Radical Regulatory Overhaul

As my October 20, 2006 comment letter demonstrates, the NYSE's proposed "reinterpretation" of the Saperstein interpretation (which adopted the trade-by-trade necessity test) is essentially a de facto rescission of the negative obligation, particularly when coupled with the de facto elimination of stabilisation requirements in the NYSE's most active stocks, the S & P 500 (indeed these are, for the most part, the NYSE's only active stocks). As I pointed out, the trade-by-trade test is the only one that can be reconciled with the word "necessary" in the text of the negative obligation. No matter how much the NYSE attempts to fudge the issue, it all comes down to one fundamental question: Is a specialist's particular trade necessary, or isn't it?
This is not exactly rocket science.

The NYSE has had no answer as to how its proposed "pattern or practice" test can be squared with the simple direct language of the negative obligation, particularly as to trading only when necessary to offset a disparity between supply and demand, a key aspect of the negative obligation the NYSE rather too conveniently ignores.

The NYSE similarly has had no answer to my point that the "pattern or practice" test is really relevant only to the affirmative obligation, as the NYSE has never had to bring a regulatory action against specialists for too active trading that caused "excess" market volatility. As I demonstrated, specialists are largely risk averse intra-day "flip" traders who "cause" excess volatility by a lack of contra-side trading in one-way markets, rather than too much trading.

The NYSE's response ignores the essence of my critique, but tries to justify the NYSE's position by "nibbling around the edges." The NYSE suggests that it is not really proposing the de facto elimination of the negative obligation because it will still retain the trade-by-trade test in certain technical situations, and that stabilisation requirements will be retained for inactive securities and trades very near the close. Further, the NYSE suggests that the negative obligation is an anachronism in automated markets because floor official approval cannot readily be obtained for certain necessary, but destabilising, transactions. The NYSE also suggests that I have failed to appreciate that the negative obligation does not preclude specialist trading to meet the "reasonably anticipated" needs of the market.

The NYSE's positions here are cosmetic fluff that fail entirely to get at the heart of the matter.
Essentially, the NYSE is attempting to use very limited technical exceptions to justify a wholesale dismantling of the negative obligation in non-exceptional situations that account for the great bulk of NYSE trading.

The maintenance of stabilisation requirements in inactive stocks is largely meaningless, as the NYSE lists hundreds of stocks that rarely, if ever, trade, and many hundreds more whose average daily trading volume is minuscule. For all intents and purposes, the S & P 500 is the NYSE market, as the component stocks in that index (and ETF volume) account for more than 90 percent of all volume. The removal of stabilisation requirements and the trade-by-trade necessity test in the S & P 500 stocks means that the specialist can freely trade (compete/interfere) against public orders in the very stocks in which such dealer trading will not be at all necessary in most instances. The NYSE has made no case whatsoever as to why this sort of unconstrained specialist trading is in anyone's interest but the specialist.

The NYSE's references to "floor official approval" and the "reasonably anticipated" needs of the market are classic red herrings. Both are very limited exceptions to normal trading situations. With respect to floor official approval, it is a meaningless truism in a world of automated trading to say that this requirement is outdated and should probably be eliminated from NYSE rules. But that hardly justifies dismantling the overall negative obligation. First, floor official approval is hardly a common occurrence, particularly in the S & P 500 stocks. Second, the requirement exists in a bizarre regulatory netherworld to begin with, as specialists can still be deemed to violate the rule even if they do obtain floor official approval. My research indicates that the NYSE has brought a number of regulatory actions against floor members, notwithstanding "floor official approval."

The NYSE can easily enforce the current rule simply by adopting some sort of procedure whereby it flags any direct destabilising trade and requires the specialist, in each instance, to demonstrate "necessity", in the same manner that the specialist would have had to make the case to a floor official prior to a trade in the physical auction.

The notion that the negative obligation does not preclude specialist trading to meet the "reasonably anticipated" needs of the market is hardly the open sesame the NYSE appears to suggest (virtually anything could be rationalised as "reasonably anticipated", but that's hardly what the rule text means). As specialists have told me over the years, this is a limited concept intended to address a situation in which a specialist becomes aware of a specific, unusual situation which may require greater than normal specialist buying or selling (e.g., to build up a position because the specialist knows he will have to sell to an usual block buyer, a situation that more typically arises in less liquid stocks, not the S & P 500). As with "floor official approval", these relatively infrequent situations can easily be addressed by case-by-case flaggings, and hardly warrant the sweeping rule revision sought by the NYSE.

The NYSE is merely trying to "hide behind" relatively rare, technical exceptions, and use this as the basis for eliminating restrictions on the vast bulk of trades not subject to these exceptions. This is grossly inadequate as a matter of fact, law, and logic.

The Post-1975 "Changes" to the Market

The NYSE makes much of post-1975 technological changes as the securities industry lurches, however haltingly, toward development of a national market system per the Congressional mandate. However, the NYSE conspicuously fails (there is no good answer) to address my point that automation, properly implemented, in fact makes it easier, rather than more difficult, for specialists to comply with the negative obligation and stabilisation requirements. If the NYSE cannot attract programmers who grasp this fundamental concept, I'd be happy to make a few referrals.

On pages 5 to 7 of its letter, the NYSE lists 11 of what it calls "significant changes" that have, in the NYSE's view, "transformed the way in which the securities markets function."

Technocrats, of course, become so seduced by technology that they cannot help but exalt form over substance. Truly, the markets today are faster, more efficient, more transparent, and generally more accessible than in 1975, but these changes have not transformed a market's core function, which remains that of providing a venue for order execution, with or without dealer intervention.

As stated above, I am a firm advocate of electronic trading so long as it is conducted on a competitively "level" playing field. That said, I must observe that the 11 changes listed by the NYSE are largely meaningless truisms having nothing to do with the issue herein, which is whether or not essentially unconstrained specialist trading in the

NYSE's most active stocks is in the interest of public investors and is consistent with the Congressional mandate in Section 11A regarding the minimisation of dealer intervention.

Only 3 of the 11 "changes" listed by the NYSE warrant comment, and not extensive comment at that. Change number 8 is the Commission's adoption of Regulation SHO, a pilot to eliminate short sale "tick" restrictions in active securities. In the NYSE's view, Regulation SHO "signals the recognition that ticks no longer serve as useful benchmarks in regulating trading."

The NYSE is clearly mixing apples and oranges here in suggesting that Regulation SHO has any bearing on the elimination of "tick" based stabilisation requirements. Short sale "tick" tests are a prophylactic tool against market manipulation by short sellers. Regulation SHO recognises that such tests may no longer be relevant to prevent manipulation of very liquid securities.

The NYSE's specialist stabilisation requirements, however, have nothing to do with market manipulation.
Rather, they are intended to assure that a monopoly dealer in a primary market does not support or initiate that market's price trend, but largely trades counter to that trend to cushion price movements.

As I pointed out in my October 20, 2006 comment letter, "ticks" are indeed a benchmark of price direction in many professional trading strategies, and any number of such strategies have tick-based components. Direct specialist influence on market price trends will not only make the market more volatile (notwithstanding the meaningless re-entry requirement), but will have an adverse impact on many public investor trading strategies. As to be expected, the NYSE had no answer for any of this.

Changes 9 and 10 listed by the NYSE have to do with differing requirements for market makers on ECNs, the Nasdaq "exchange", etc. Again, these are essentially meaningless truisms and have no necessary correlation to the NYSE proposal. NYSE specialists are free to match bids/offers posted on other markets, and are free to trade as "public" customers in those markets.
To the extent such away "market makers" send orders for execution to the NYSE, the volume is minuscule in relation to public order volume, and hardly warrants permitting specialists to interfere/compete with that broad public volume. There are no "unfair" competitive advantages here, given the specialist's unique role in the primary market.

But an even more important objection here to the NYSE's position has to do with the fact that the NYSE has (rather too conveniently) ignored a profound market structure distinction. The other markets the NYSE refers to are largely geographically dispersed, competing market maker venues. The Commission has long recognised that "tick" tests and trade-by-trade necessity tests are impractical is such dispersed, multiple market maker environments. But such requirements make perfect, indeed essential, sense in a monopoly market maker environment. It is the existence of the negative obligation, with its strict trade-to-trade necessity test, that makes the specialist's monopoly status palatable as a matter of law. Absent such a negative obligation, a specialist is uniquely situated with the exclusive franchise to be able to trade at will against a primary market's order flow, which is not only grossly anti-competitive per se, but is a veritable license to print money. Surely, the SEC staff must understand this very fundamental distinction between NYSE specialists and other market makers.

I never thought I'd live to see the day that the august NYSE would attempt to equate its specialists with Nasdaq market makers. But if the NYSE is truly serious in this regard, let it propose and implement a competing market maker system. I will not hold my breath.

The Heart of the Matter: Section 11A

In its comment letter, the NYSE notes in presenting its principal argument that as a result of the 11 "changes" it listed, "specialists no longer have a meaningful ability to direct or influence trading or control the quote. Instead, the market has become increasingly driven by limit orders and marked by a dramatic increase in competition" by market participants (i.e., the public) not subject to the trading restrictions imposed on the NYSE's monopoly dealer. Apparently outraged by this (Congressionally mandated, as discussed below) development, the NYSE cries out, "This creates an environment where the specialists are simply unable to compete." This echoes the NYSE's complaint in 2006-76 that "specialists have fewer opportunities to control the price of or dominate the market in a security, particularly liquid securities in active trading situations."

As I noted above, the NYSE offers no explanation as to why the specialist's algorithm cannot be programmed so that the specialist can trade lawfully notwithstanding the new, faster electronic environment.

But be that as it may, I would, at a minimum, give the NYSE high marks for candor here, if not for subtlety or intelligence. There are two aspects of the NYSE's representations here that are truly disturbing:

(1) By virtue of its inelegant, but unintentionally honest, phraseology, the NYSE is indicating that it still has no clue whatsoever about what the negative obligation means and how to enforce it, notwithstanding the recent scandal that focused on the NYSE's grossly inadequate comprehension and enforcement of the negative obligation. The SEC Market Regulation staff clearly need to confer with the SEC Enforcement Division on this.

(2) The NYSE appears entirely clueless that the market developments it is complaining about are resulting in exactly the kind of market contemplated by Congress in Section 11A, a fast, efficient market in which the need for dealer participation becomes significantly diminished.

It is worth remembering that the negative obligation (with limited technical exceptions) precludes specialist dealer trading unless conducted in a stabilising manner and necessary to offset a disparity between supply and demand. Simple, straight-forward stuff. So how exactly does the NYSE bemoan the fact that specialist's cannot "control" or "influence" trading, activities they were never supposed to engage in in the first place? And the NYSE goes even further, bemoaning the fact that specialists cannot "control" prices or "dominate" the market in liquid securities" (where, of course, their participation is required far less than in illiquid securities).

It goes without saying that, under a properly enforced negative obligation, specialists should never have "controlled" prices, "dominated" markets, "influenced" trading, etc. Making a market appropriately under the negative obligation hardly requires such activity as to the maintenance of truly fair and orderly markets.
The NYSE has no self-consciousness whatsoever that it has effectively acknowledged (as the professional trading community has long known anyway,and has frequently complained about specialist dealer account interference with routine trading) that the inmates have been running the asylum. And since when has it been the function of a monopoly market maker subject to a strict negative obligation to "compete" with public orders capable of execution without dealer intervention?

Even after two disturbing trading scandals in less than 10 years, the NYSE still just get it. It appears that the recent specialist trading scandals may well have been just the tip of an iceberg.

But even more to the point, the NYSE seems oblivious about what the 11 "market change" factors it lists really mean. Particularly in the S & P 500 stocks, the NYSE market is largely "making" itself. In an efficient, automated environment in liquid securities, there is often a greatly reduced need for the specialist to "make" a market already being "made" by natural public order flow. This entirely healthy development is exactly what Congress had in mind in Section 11A(1)(C)(v), when it stated that, in a national market system, it is in the public interest for "investors' orders to be executed without the participation of a dealer."

As a matter of law, the NYSE cannot have its cake and eat it too here. The SEC simply cannot permit the NYSE to create, on the one hand, a fast, efficient electronic market in active stocks that obviates to a large extent the need for dealer intervention, and then, on the other hand, approve rule changes that permit the monopoly dealer to interfere with public order execution anyway. There is a very simple reason why specialists cannot "control" trading anymore: the real market, which is resolving the matter very efficiently, quite often doesn't need them. And both the SEC staff and the NYSE need to start understanding what is really happening here, because this is exactly how the markets are supposed to function in a national market system.

But to the extent there is a genuine need for dealer intervention, the current trade-by-trade necessity test, and a properly programmed specialist algorithm, can certainly accommodate such legitimate demands. The NYSE has made no case whatsoever to the contrary.

Far from being stuck in some 1975-era time warp, I am taking a very forward-looking view as to what the practical application of Section 11A really means. And given that the national market system is evolving, as Congress intended, toward the minimisation of dealer

intervention, it is obvious that the negative obligation is an essential complement to Section 11A.
The negative obligation, with its trade-to-trade necessity test, is, in fact, not some regulatory relic, but a critical specialist regulation that is absolutely essential for effectuating the purposes of Section 11A.

Viewed in this light, it is clear that the icon of reaction is the NYSE. The practical effect of the NYSE proposal is to roll the clock back not simply to 1975, but to the pre-SEC world of the early 1930s, before the negative obligation and the Saperstein interpretation, when specialist "control" of trading was a fact of life imposed on the hapless investing public. And, as is embarrassingly evident from the NYSE's inept discussion, this nonsense has apparently been going on anyway until the "machine" is finally
(thankfully) bringing it to an end.

In none of its "hybrid" proposals has the NYSE paid more than the most superficial lip service to Section 11A. But what is even more shocking is that neither the Commission nor the SEC staff have presented any analysis whatsoever of "hybrid" issues in light of Section 11A. (I refer not simply to the instant matter, but the refusal of the SEC staff to analyse specialist go along trading in light of Section 11A and the negative obligation as well).

The regulators are not just asleep at the switch here, they are absolutely comatose.

The NYSE's Affirmative Misrepresentations

The NYSE has responded in the worst possible way to the evolution of the national market system and the concomitant minimisation of the need for dealer intervention. The NYSE is attempting not only to "replicate" in cyberspace the specialist's time/place advantage, but to extend such advantage in a manner far beyond that which existed in the physical auction (and with none of the "fishbowl" ameliorating factors of the auction).

In my October 20, 2006 comment letter, I demonstrated how the NYSE has acted in this regard. In light of this critique, the NYSE has been forced to acknowledge that the NYSE does indeed have informational advantages in the "hybrid" market, but suggests that these advantages are "slight." Below, I discuss this and other significant misrepresentations by the NYSE.

(1) NYSE Misrepresentation: The NYSE contends that specialists have only a "slight" informational advantage in the "hybrid" market.

Reality Check: The specialist's informational advantage is anything but "slight". For example:

(i) the specialist's algorithm has exclusive knowledge of floor broker hidden orders and thus knows at what prices to compete with them, or where to "price improve" by the minimum increment to deny executions to them;

(ii) the specialist's algorithm has exclusive knowledge of incoming marketable orders (this point is also discussed below), and has the exclusive ability to trade with such orders if the specialist so chooses; and

(iii) the specialist's algorithm has exclusive knowledge of impending sweep transactions, and has the exclusive ability to "layer the book" to take the contra side at advantageous prices in response to this information.

Clearly, the "slight" informational advantage consists of giving the specialist highly material, non-public market information. In the physical auction, the specialist might from time-to-time have had non-public information, but could not act on it until the information was disclosed to the public pursuant to the NYSE's order exposure rules. This was entirely in accord with the disclose-or-abstain-from-trading standard as to insider trading.

In the "hybrid" market, however, there is no disclosure to the market before the specialist can trade. The specialist not only has material, non-public market information, but has the exclusive ability to act on it.

This is insider trading under any legal standard, and the SEC staff have persistently refused to come to terms with it.

In a letter littered with misrepresentations, the NYSE's contention that specialist's enjoy only a "slight" informational advantage is the most egregious of all.

(2) NYSE Misrepresentation:
The NYSE contends that while the specialist's algorithm has knowledge of an incoming non-marketable
(limit) order, the algorithm cannot trade with the order until the order is publicly quoted. Therefore, says the NYSE, other market participants have a "similar opportunity" to trade with the order, a notion reinforced by a "time delay" (between entry of the order into NYSE systems and its being quoted) that inhibits the algorithm from effecting a trade.

Reality Check: The NYSE should be ashamed of itself for this obvious garbage. Does the NYSE believe no one has penetrated the technical morass of its rule submissions? The specialist's algorithm is deeply embedded in NYSE systems and immediately reads the incoming order. The "time delay" (a matter of nanoseconds at best) is, in practical terms, an entirely fictional construct. The specialist's algorithm will effect a trade the absolute instant an order is quoted, because it has a head start over every other market participant. The NYSE is overly "slick" about the "time delay" nonsense; the only "time delay" that would put outsiders on an even footing with the specialist's algorithm is a time delay inhibiting the algorithm for some period after the order is quoted so that the rest of the world had an actual opportunity to react. But, of course, this is not what the NYSE has provided.

The NYSE well knows that it has built a system that will deliver an execution to the specialist's algorithm 100 percent of the time in this situation.
The NYSE is not dealing fairly with the public, or with the Commission, by suggesting otherwise.

(3) NYSE Misrepresentation: The NYSE contends that floor broker hidden orders have a "similar opportunity" to compete with the specialist's algorithm as to executions against incoming marketable orders.

Reality Check: I discussed this issue specifically in my correspondence on 2006-36, and the NYSE never disputed my analysis. As I noted therein, floor broker hidden orders in between the quote trade only with incoming orders that are published. But marketable orders are never published, but simply receive an immediate electronic execution. The entire universe of "price improvement" trading against incoming marketable orders is the exclusive preserve of the specialist's algorithm. Floor broker hidden orders do not have a "similar opportunity" to trade, they have no opportunity to trade whatsoever.

Shame on the NYSE for indicating otherwise.

(4) NYSE Misrepresentation: The NYSE contends that, under its proposed de facto rescission of specialist stabilisation requirements, "specialists will continue to assume risk by committing capital to cushion market volatility when all other market participants are trading with the trend and destabilising the price of the security."

Reality Check: We all live in hope that the monopoly dealer will continue to stabilise the market in return for the exclusive primary market franchise. But what the NYSE has left out here in its eloquent ode to specialists as "cushioners" is the fact that what it is actually proposing is to allow the specialist to trade with the trend and destabilise the market along with the rest of the world.

One couldn't make this up if one tried.

(5) NYSE Misrepresentation: The NYSE attempts to defend its "pattern or practice" approach as a replacement for the traditional trade-to-trade necessity test (the Saperstein interpretation). Toward that end, the NYSE acknowledges that in and out specialist profit taking "would in fact violate the specialist's negative obligation as it impedes the opportunity for public orders to be executed against each other without undue dealer intervention within the context of the current market."

Reality Check: The NYSE has expressed a noble sentiment here. In fact, it comports entirely with my analysis in my October 20, 2006 letter, in which I expressed concern that the "pattern or practice" approach would not focus on this type of behaviour.

The problem for the NYSE, though, is that this is not what it represented in its rule submission. The NYSE proposed a "pattern or practice" test for the negative obligation that focused on too active specialist trading that resulted in "excess" market volatility. I pointed out the absurdity of this approach based on the NYSE's actual, historic experience with the negative obligation, and noted that the only practical way to enforce the negative obligation is to focus on specialist trading at or within the quote. (Indeed, this is exactly the type of trading at issue in the recent specialist trading scandal involving breaches of the negative obligation, which were apparently detected by application of the trade-to-trade necessity test).

So the NYSE has apparently abandoned what it is still on record as asking the Commission to approve. But there's a much more fundamental problem here, and the NYSE is oblivious to the fact that it is now running around in circles on this issue.

The only way to know whether the specialist's trading at or within the quote displaces public orders is to take a trade-to-trade approach to the negative obligation. Either a particular trade displaces a public order or it doesn't. There is no "pattern"
involved in such a determination, unless the NYSE is suggesting that there is no violation of the negative obligation unless a significant number of orders are displaced in a significant number of trades, a horrendous position for a regulator to take. (I can't believe this is the NYSE's position).

So this is the corner the NYSE has maneuvered itself into. It submitted a proposal to adopt a "pattern or practice" test premised on the specialist creating "excess" market volatility. It has now effectively rejected that approach, but what it is calling a "pattern or practice" approach is, in reality, the Saperstein interpretation's trade-to-trade approach (which is the only way the negative obligation can be effectively enforced., and is the reason the Saperstein interpretation has endured for some 70 years).

Hint to NYSE: Your flip-flop here amply demonstrates the wisdom and contemporary applicability of the Saperstein interpretation, and the total absence of any need for a "reinterpretation."

Again, one couldn't make this stuff up if one tried.

(6) NYSE Misrepresentation: The NYSE contends that its proposal contains "detailed guidance" on how specialists should comply with the negative obligation.

Reality Check: In fact, the rule submission contains no "detailed guidance" whatsoever.

(7) NYSE Misrepresentation: The NYSE contends that specialists do not have a monopoly on algorithmic trading, and that all market participants are free to employ "algorithmic-based trading strategies."
Further, the NYSE notes that all market participants have the ability to trade electronically. And (my personal favourite), "all orders on the Exchange will be executed, consistent with their instructions, in accordance with Exchange rules" (as if a regulated market could operate otherwise, but this gives some idea of the "quality" of the NYSE's letter).

Reality Check: The NYSE has outrageously fudged the issue here. Of course market participants use algorithm-based strategies to enter Superdot orders.

But these algorithms cannot compete with the specialist's algorithm, which is deeply embedded in NYSE systems (no external Superdot order entry for the specialist!) and gets first crack at incoming order flow before the rest of the world (external algorithm or not) can react to it. Simply put, the specialist's algorithm has knowledge of orders the instant they enter NYSE systems, but the algorithms of other market participants acquire knowledge of limit orders only after they are "quoted", at which instant, as I discussed above, the specialist has already traded.
And the outside world (unlike the specialist's algorithm) has no knowledge of incoming marketable orders but must simply view a trade report on the "tape."

In practical terms, the NYSE has created the most "unlevel" competitive playing field imaginable.

And the NYSE wonders why the professional trading community views the "hybrid" market with muted enthusiasm at best.

The existing specialist rules are intended to serve the investing public and should be retained in their current form. It is a measure of the NYSE's desperation that it has had to resort to the misrepresentations and distortions noted above to try to support its entirely unwarranted proposal. The NYSE's Orwellian Ministry of Truth lives on.

The SEC staff cannot possibly accept the NYSE's representations at face value after their falsity has been specifically demonstrated.

Conclusion

The NYSE tries to make "specialising" look like an act of selfless heroism that would put Mother Teresa to shame. But the reality is that specialists are simply profit-driven position traders, with an overlaid veneer of market making responsibility. (And there's nothing at all negative about being profit-driven, so long as all rules are obeyed and the competitive playing field is "level").

While specialist profits are down from their (egregious) historic highs, the business is still profitable by real world standards. And all projections are that profitability will increase significantly as "hybrid" market volume explodes.

If the SEC approves the instant proposal, the practical effect will be to permit largely unconstrained specialist trading, with highly anti-competitive advantages, against greatly increased order flow. In the zero sum game of trading, such enhanced specialist profitability will represent a huge transfer of wealth at the direct expense of the investing public.

Shame on the Commission and the SEC staff if they are so naive as to let this happen.

I will close with the same observations I made in my October 20, 2006 letter, as they go to the heart of the matter.

It is not the Commission's task to ensure NYSE specialist profitability levels by maximising their proprietary trading opportunities.

It is the Commission's task to enforce applicable law strictly, to put the interests of public investors ahead of dealer interests, to maximise public order interaction without dealer intervention, and to create as "level" a competitive playing field as possible.

It really is that simple.

Sincerely yours,

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