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July 20, 2005

Dear SEC:

It is not a pretty sight when the NYSE marketing machine's hyperbole about a "hybrid market" gives way to the grim, depressing reality of what the NYSE has actually proposed.

The NYSE's rule submission is a rather slap-dash affair, with five amendments so far in what appears to be a process of making it up as they go along. The proposal is littered with self-invented jargon and flavored with intelligence-insulting bromides about "trading having to be conducted in accordance with SEC and NYSE rules." (Were they going to say trading did not have to be so conducted?) Even more critically, in a number of instances the NYSE has proposed radical changes to its time-tested procedures that have served the broad public well, without even acknowledging that that is what it is doing, much less providing a reasoned, analytic justification for its actions.

To anyone familiar with the fundamental, underlying market structure issues, the notion that the NYSE has proposed a genuine "hybrid market" is laughable. In this context (if words are to have traditional, plain meanings in fairness to public comprehension), a "hybrid market" would mean a blending of the NYSE's floor-based, agency-auction structure with a screen-based, automated off-floor structure to create a structure that is new and unique and combines the best elements of both. The NYSE has not proposed anything of that sort.

As I demonstrate below, the NYSE proposal allows greater, but still, and anti-competitively, limited electronic access to floor-based liquidity, but would transform the economic dynamics of large-size order execution from favoring of-floor interests to favoring floor broker interests, and would give floor brokers greater latitude in elbowing aside public limit orders on the public limit order book.

Notwithstanding the recent specialist floor trading scandal, involving wide-spread ignoring of the negative obligation and trading ahead of public customers, the NYSE is actually proposing to establish a hidden electronic market, for the exclusive use of specialists, in which they may profitably capture "dealer turns" (with no net public economic benefit) in complete contravention of the negative obligation. And specialists would also be permitted to trade ahead of their customers and apparently engage in a unique form of insider trading. In addition,the NYSE is proposing to legitimize a practice whereby floor brokers have routinely permitted specialists to violate a fundamental public protection rule.

It is clear that the NYSE has not proposed any meaningful changes to its fundamental market structure, but rather has proposed to distort that structure to favor floor trading interests even more than they are favored under current rules - the exact opposite of what a genuine hybrid market would seek to accomplish.

There is a word that perfectly describes the "market" the NYSE is proposing.

That word is not "hybrid."

That word is "mutant."

THE NYSE MUST RECAST ITS PROPOSAL IN PLAIN ENGLISH

Before discussing the substance of the NYSE's proposal, I would like to reiterate concerns raised in my earlier correspondence about the need for the NYSE to recast its proposal in plain English and be held to the same plain English standards as the SEC.

I will not repeat the bulk of my earlier discussion here (but I ask that it be incorporated by reference herein). I will, however, particularly emphasise two points:

1. The NYSE must be made to use the term "order" rather than "broker agency interest file" or "specialist layered interest file." The NYSE's jargon does not at all square with SEC and NYSE rules, which speak of "orders", not "interest." The NYSE's terminology obscures (perhaps intentionally) the reality of what it is proposing, namely that floor brokers are entering "go along" orders (what the NYSE calls "parity") that will compete directly with, and siphon executions away from, the orders on the public limit order book that would otherwise be executed in strict price/time priority, the schematic for order execution in every other major market anywhere in the world. The term "specialist layered interest file" obscures the fact that specialists are entering dealer orders that compete directly with, and siphon executions away from, public go along orders (largely institutional) that have hitherto always been entitled to supersede specialist dealer orders (unless the dealer is liquidating a position).

2. The NYSE needs to acknowledge that the floor broker go along orders, and the specialists' dealer orders, are being entered onto what are, de facto, separate limit order books that compete directly for executions with the public limit order book(in the case of broker orders) or public go along orders (in the case of specialists).

Plain English matters a great deal. The relative dearth of public comments on the NYSE's proposal (and the fact that those who have commented have done so only with respect to the broadest aspects of the proposal) stems in large measure from the fact that most securities professionals (and I've spoken to a fair number) simply do not understand it.

THE MUTATED MUDDLE: WHY THE NYSE HAS NOT PROPOSED A GENUINE "HYBRID MARKET"

Sadly, the NYSE appears to have seduced itself with a phrase ("hybrid market") without really understanding what it means, much less how to implement it. Yet, the elements of a genuine hybrid market are a matter of common knowledge, certainly among those who have had to consider the transformation of floor-based markets to screen-based trading. Virtually all markets start out on the path to transformation by considering whether a "hybrid" blending of floor and of-floor would work, as an alternative to completely abandoning floor-based trading. The answer has invariably been no, typically because of liquidity versus expense issues in what are, in contrast to the NYSE, largely or exclusively dealer markets. The NYSE is, however, quite unique both in the depth and liquidity of its market, and in its agency-auction order interaction, with moderate levels of dealer intervention. If a genuine hybrid market could, in fact, be implemented anywhere, the NYSE is probably the only place where that could happen, as floor-based agency order price competition may be integrable with screen-based liquidity pools. Or not, but it would certainly be an interesting experiment, one in which the NYSE floor might well thrive, albeit almost certainly with different participants (broker-dealer and instituional traders, and highly skilled, strategy-specific floor brokers) and different liquidity initiation rules to compete with/supplement screen-based liquidity. That is why the prospect of a genuine NYSE hybrid market is so promising, and why the NYSE's dismal, far-from-the-mark proposal is so disappointing.

A genuine hybrid market that successfully blends floor-based and screen-based trading would contain most of the following elements (the list is representative rather than exhaustive, as each market has its own unique considerations):

1. The liquidity that maket participants seek to access must be located both on and off-floor, accessible from both, and linked within the market's overall systems. A very significant indication that the NYSE is not changing its fundamental market structure at all is the fact that the liquidity to be accessed continues to be entirely floor-based. A market participant can effect or participate in a trade only by sending an order to the NYSE's trading floor or its floor-liquidity based systems. For this reason alone (there are others), the NYSE essentially remains what it has always been, a floor-based market rather than a floor/screen hybrid.

The ability to effect an automated execution against floor-based liquidity does not at all transform the market structure of a floor-based market. U.S. exchanges have for years offered such executions without calling themselves hybrid makets. Indeed, when the NYSE introduced its Direct (automatic execution) system, it (quite rightly) made no claim that it had become a hybrid market. If the Direct system did not create a hybrid market when it was introduced, the proposed expansion of the system (welcome in some, but not all, particulars) can hardly be said to create such a market now.

2. A genuine hybrid market would maximize the strengths of off-floor, screen-based and automated sytems, while integrating them with floor-based liquidity, which could be entered into auto ex systems as well. One would expect to see, for example, auto ex orders being executed directly against one another, instead of, in the NYSE's floor-based model, being executed only against floor-based liquidity. One would also expect to see

algorithmic trading in which auto ex orders are executed against one another in between the prevailing quotation to provide price improvement for both of them, without dealer intervention or interpositioning. The NYSE's proposed algorithmic model, which confers monopoly privileges on a floor-based participant (specialist) can be hardly be said to be consistent with what one would expect to see in a genuine hybrid market. One would also expect to see crossing and other discrete large order matching and large order execution facilities, but none are proposed by the NYSE, presumably because it has not been able to figure out how to "rig" them to the benefit of its floor trading community.

3. In a genuine hybrid market, liquidity initiation/market making would occur in both the floor and screen environments, and would be linked within the market's overall systems. A monopolistic, unitary, floor-based market maker system is the exact opposite of what one would expect to see in a genuine hybrid market. Indeed, it is an oxymoronic concept with respect to a genuine hybrid market. If the NYSE were serious here, it would allow for off-floor, screen-based market making in competition with its floor-based specialists, which, in turn, would potentially add greatly to the depth and liquidity of the NYSE market. But far from allowing such screen-based market making competition, the NYSE has gone in the exact opposite direction, proposing an even greater specialist monopoly by means of "algorithmic" trading in which only the specialist can indulge. This is so far removed from what a genuine hybrid market would provide that one can only shake one's head in despair at what is either the NYSE's naivete, or (more likely) its disingenuousness.

4. A genuine hybrid market would provide for an equilibrium of order display and order execution opportunity as between on-floor and off-floor market participants, with a minimum of artificial intermediation. A market participant, wherever situated, would have equal ability both to access liquidity (wherever displayed), and to display liquidity in whatever context/environment the market participant chose. In other words, a market participant could freely access, and freely display, liquidity, whether located on or off a physical trading floor. The NYSE proposal adresses (and not entirely satisfactorily) only one-half of the equation. By proposing to remove order size limitations in its Direct system, the NYSE is giving off-floor market participants greater access to floor-based liquidity, although, as noted above, such enhanced ability to effect automated executions against floor-based liquidity can hardly be said to transform the NYSE into a hybrid market.

The NYSE's critical failing, however, is on the opposite side of the equation in its denying to off-floor market participants the ability to display liquidity on the same terms as on-floor participants. The NYSE's reasons are self-serving, and completely at odds with what one would expect to see in a genuine hybrid market. Quite simply, the NYSE maintains arbitrary restrictions on the types of orders off-floor market participants may enter to display liquidity. Institutions and broker-dealer trading desks may enter market and limit orders into the NYSE's superdot system, but are precluded from entering so-called "CAP" orders, a kind of go along order ultimately represented by the specialist in a somewhat mechanical fashion. (The NYSE's CAP order rules are particularly obscure and virtually incomprehensible to outsiders.) This restriction is intended solely to ensure that floor brokers continue to receive such orders (commission income). But, as floor brokers tell me, all they do when "capping" an order is give it to the specialist, who incorporates it into the public limit order book and represents it thereafter. The floor broker, though, will bill the institutional customer, which is none the wiser as to how the order was actually handled and executed. This ridiculous state of affairs cannot be allowed to continue. Off-floor market participants must be given the right (consistent with what a genuine hybrid market would afford) to display liquidity by entering CAP orders themselves directly into the superdot system, bypassing the floor broker and attendant commission expense for services barely rendered. No genuine hybrid market would discriminate in this manner against off-floor market participants seeking to display liquidity by requiring such unnecessary and costly floor broker intermediation.

Similarly, consistent with what one would expect in a genuine hybrid market, off-floor market participants must be given the right to display liquidity by entering directly onto the display book the electronic go along (parity) orders that floor brokers would be permitted to enter under the NYSE's proposal. As matters stand, institutions that wish to "go along" with the market will be forced to assume the expense of value-less intermediation by having to send orders to floor brokers, who will then enter the order onto the display book, which will then execute the order automatically as contra side interest enters the market. And, of course, the floor broker will bill the institution for services (?) rendered. As with CAP orders, the institution should be permitted to choose whether to use a floor broker to "work" an order, or enter a go along order directly onto the display book, as it can with other types of orders.

Alternatively, if the NYSE refuses to preclude these forms of forced intermediation, the SEC should demand either: (i) the NYSE adopt a rule precluding specialists and floor brokers from charging commissions for any part of an order they do not personally execute, with the precedent being the "no commission" specialist superdot rule; or (ii) the NYSE adopt a rule mandating that floor brokers and specialists disclose to their customers exactly what part of an order they did not personally execute, but for which they are nonetheless charging a commission.

It is, I suppose, the NYSE's prerogative to attempt to legislate protected niches for its floor trading constituency. But it is absurd for the NYSE to maintain and enhance floor-based monopolies regarding order entry/liquidity display, propose to change the rules regarding large-size order execution to the economic benefit of floor broker interests, and propose a new floor participant monopoly (specialist algorithmic trading), while telling the world it is transforming itself into a "hybrid market."

Despite the NYSE's wink-and-a-nod to the screen-based world, it is clear, when one strips its proposal to its bare essentials, that the NYSE is largely mutating its existing floor-based agency-auction structure to advance the interests of its floor trading community, but not at all transforming that structure into something that truly integrates floor and off-floor trading environments.

This is not simply a matter of putting forth contrasting visions of what a "hybrid market" might look like. The NYSE has simply not put anything forward that can be seriously discussed in those terms to begin with. There is such a huge disconnect between the grandiosity of the NYSE's rhetoric and the reality of its proposal that the term "gross misrepresentation" is not inappropriate here. The SEC may not want to confront the NYSE's marketing machine on this point, but it is absolutely in the public interest that the NYSE be made to properly characterise its proposal.

The NYSE's proposal recalls the famous American telly commercial of years back when a hamburger chain derided its competitors with the classic tag-line, "Where's the beef?" When one lifts the huge bun (the marketing hyperbole) covering the substance of the NYSE's proposal, one finds very little "beef", and what there is is quite raw and difficult to digest.

"Mutant" indeed.

ACCESS TO FLOOR-BASED LIQUIDITY: WHAT THE NYSE GIVETH, BUT MORE IMPORTANT, WHAT THE NYSE TAKETH AWAY

1. Access to Floor-Based Liquidity: Benefit

In what is probably the most significant and helpful aspect of its rule submission, the NYSE is proposing to remove restrictions on the size of orders that can be entered into its Direct system. (The limitation is currently 1099 shares). In addition, the NYSE is proposing that orders entered into the Direct system that cannot be fully executed at the published bid or offer will "sweep" the book until fully executed, the limit price on the order is reached, or a pre-determined auto ex shut-off point is reached (what the NYSE, in a strange formulation, calls a "liquidity replenishment point"). A sweep order would receive two prices: the price of the current bid or offer, and a "clean up" price representing the lowest price (in the case of an order to sell) or the highest price (in the case of an order to buy) at which the unfilled balance of the order (what the NYSE's unhelpful jargon calls the "residual") can be filled at or above (below) its limit price. In other words, the balance of the order remaining after trading at the published bid or offer will not be given the opportunity to trade at intervening price levels to receive a better overall price, as has been long-established practice under current rules, but must accept a clean up price, which by definition is the worst overall price in the market. The removal of order size restrictions in the Direct system is a clear public benefit. The sweep clean up price methodology is a benefit only to those trade initiators who are seeking such a price; otherwise, there is significant economic dislocation here for them with respect to the traditional pricing of large orders that cannot be filled at published bid or offer prices. Arguably, limit orders on the public limit order may benefit, although they have advertised to trade initiators (in the NYSE's opened book) their willingness to trade at their limit prices. The NYSE, with SEC concurrence, has historically viewed executions at limit order posted prices, rather than at a clean up price, to be entirely appropriate in this sort of trading situation. No, the principal beneficiary of the clean up methodology will be hidden floor broker go along orders, and possibly the specialist's hidden dealer orders, which can be entered onto the display book with knowledge of where the public limit orders are on the display book, and where they can be entered in relation to those orders to take advantage of possible sweep executions, thus receiving a premium (sell order) or discount (buy order) over the current published market price.

2. Access to Floor-Based Liquidity: Significant Disadvantage

The NYSE's proposed clean up pricing for sweeps seriously transforms the economic dynamics of large-size order executions, replacing a trade initiator's current ability to get the best possible price with a strict requirement that only the worst possible price can be obtained. This is a huge financial penalty for the privilege of seeking an automatic execution, and the exact opposite result from what a genuine hybrid market, that seeks to attract and reward liquidity, would want to achieve.

And please, NYSE, no bleeding-heart screeds about "walking the book", a practice the NYSE has long deemed entirely appropriate to give a trade initiator the opportunity to trade with limit orders at prices at which those orders have expressed a willingness to trade. The NYSE has always (and sensibly) taken the position that clean up pricing is appropriate in block cross transactions, where the parties to the trade have agreed to complete the "cross" at a premium or discount to the current market price. The NYSE (with SEC approval) mandates that orders already in the market be given an opportunity to share in the premium or discount under procedures specified in its rules.

The NYSE has clearly distinguished block cross premium/discount trades from situations where a market participant has a large order on only one side of the market, and has not made a pre-determined decision to complete the order at a premium or discount. The NYSE permits the trade initiator to trade with the published bid or offer and then, with respect to any unfilled balance of the order, the trade initiator may choose either to complete the order at a clean up price, or by means of executions at whatever better prices are otherwise available. This means that the trade initiator has always been able to trade with limit orders on the public limit order book at their limit prices, if the trade initiator so chooses. Price improvement, in this context, is, of course, a zero sum game. To the extent a trade initiator gets an improved price, the limit orders do not, but the NYSE's public policy has been to "reward" the trade initiator here, with no real detriment to the limit orders, which simply trade at their limit prices and in fact benefit from the trade initiator's liquidity.

This is sound policy that fairly balances the interests of the trade initiator and the public limit order book. So why is the NYSE now seeking to transform the economic dynamics of these transactions to the detriment of the trade initiator? The answer is simple: for the first time, there will now be hidden floor broker and specialist go along orders on the Display Book, and the NYSE has determined to make sure they are rewarded at the expense of the trade initiator. As with so much else in the NYSE's rule submission, a proposed benefit to off-floor market participants (enhanced automatic execution) is compromised by the "tilt" to floor trading interests, who can be expected to be the major beneficiaries of clean up pricing.

Clearly, the trade initiator should be given the same choice as exists under current rules. See my discussion below as to the appropriate pricing for away from the market sweep transactions.

DISPLAY OF FLOOR-BASED LIQUIDITY: THE NEED TO PROTECT THE PUBLIC LIMIT ORDER BOOK

1. "Parity" and the Antiquated Fiction That "A Trade Clears the Floor"

Before reviewing the specifics of the NYSE's proposal as to how orders on the Display Book would be executed (a proposal heavily "tilted" in favor of the NYSE trading floor community), I would like to review certain fundamentals as to how the NYSE currently conducts its auction. In significant particulars, the NYSE trading mechanism is premised on principles that bear no relevance to modern markets; indeed, the NYSE's schematic for determining which orders actually get to participate in any given execution finds no counterpart in any other major market anywhere in the world.

NYSE Rule 72 is the fundamental rule governing which orders get to participate in a trade, and articulates what NYSE jargon calls the "3Ps": priority, parity, precedence.

(i) Under Rule 72, the first bid or offer publicly announced in the auction at a particular price has priority for execution in the next trade at that price.

(ii) Once a trade takes place, what had been non-priority bids or offers (but previously announced in the auction) are deemed to be re-entered on "parity", meaning that they split executions ("go along") with those bidding or offering. The NYSE refers to this process of eliminating the time priority based on time of order entry as "a trade clears the floor" of such time priority, with a "new auction" then being conducted.

The public limit order book may contain many limit orders at a particular price, but the specialist makes only one bid on behalf of the book. Each individual floor broker, who may have only one order, is also permitted to make one bid. In active stocks, a trade for as little as 100 shares (and which may be an auto ex execution) erodes the time priority of limit orders on the public limit order book, orders which may have been entered well prior in time to a floor broker's even showing up in a trading crowd. For all practical purposes, the public limit order book is forced into unequal splits all day long with floor brokers representing go along orders, as the vast majority of trading in active stocks with floor broker participation is conducted on a go along ("parity") basis.

For example, if the specialist is making one bid on behalf of five orders on the public limit order book, and four late-arriving floor brokers are each making one go along bid on behalf of a single order each is representing, the public limit order book will receive only 20 percent of a trade, and each floor broker will receive 20 percent (collectively 80 percent), even though the floor broker orders may have been entered later in time than the orders on the public limit order book. If the market then moves away from the limit prices of the orders on the public limit order book, they will go unfilled (because they have had to split executions rather than be executed in time priority) even though they were entered prior in time to the floor broker go along orders. It is little wonder that the NYSE was so fiercely opposed to the "depth of book" alternative in the SEC's National Market System Release; virutally alone among world markets, the NYSE does not even fully protect the transparent, fully-disclosed public limit orders on its own public limit order books.

(iii) Rule 72 also articulates a concept called "precedence based on size", meaning that a bid or offer that can trade with the entire size of an incoming order may supersede lesser-size go along orders or the public limit order book (which itself may claim precedence). In practice, NYSE specialists have told me, precedence is rarely, if ever, invoked, as "trading crowd culture" is to split executions equally among all go along traders, so that floor brokers are not "embarrassed" by non-participation in a trade. In essence, specialist/floor broker "accommodation" (collusion?) results in specialists routinely failing to exercise their fiduciary duty on behalf of public limit orders on the public limit order book to claim precedence to ensure that the orders they represent as agent are in fact executed.

2. The NYSE's Proposed "Triple Entry" Display Book

In order that floor broker go along orders and specialist dealer orders have an opportunity to participate in the expanded range of automatic executions likely to result from the removal of order entry size retrictions in the Direct system, the NYSE is proposing that floor brokers and specialists be permitted to enter orders onto the display book, but not in a way that would integrate their orders with the conventional public limit order book.

The NYSE proposal here is subtle (I suspect intentionally so) about how everything is in fact integrated into the display book, and its obfuscatory jargon about "broker agency interest files" and "specialist layered interest files" is singularly unhelpful. In earlier correspondence, I suggested the presence of three competing limit order books. I would like to refine that somewhat: it is more like three "mini books", each housed in the overall Display Book, and each with its own order execution schematic.

Think of a three-column format in the Display Book, Columns A, B, and C. (This may not be literally what it looks like in the NYSE's ultimate planning, but, conceptually, it is absolutely what the NYSE is proposing).

(i) Column A is the public limit order book, with orders arrayed vertically in price/time priority, as each order will be executed only after the order above it in time priority at that price has been executed. Orders on the public limit order book at every price level are fully disclosed in the NYSE's opened book product.

(ii) Column B contains orders entered by floor brokers that will "go along" with orders executable at the same price, and split executions with other orders executable at that price. Imagine, at each price level, that the orders are arranged horizontally, as they will each participate, to some extent, in each trade (under most circumstances) at that price level. Floor broker go along orders may be fully disclosed or hidden (what NYSE jargon calls "reserve interest") at the discretion of the floor broker entering the order. To be represented in the published bid or offer, at least 1000 shares of the broker's go along order must be disclosed (the balance may be hidden). In practice, most floor broker go along orders below the published bid or above the published offer can be expected to be hidden.

(iii) Column C contains an order for the specialist's dealer account (only one order at each price level, obviously, as there is only one specialist). As with the floor broker's go along orders, the specialist's order may be disclosed or hidden. Under the NYSE's proposal (and in a radical departure from what is currently permitted), the specialist's order can go along with floor broker go along orders (Column B). (Floor broker go along orders are typically for the accounts of instituional customers). The specialist's go along order could not be exectuted so long as there are public limit orders (Column A) executable at that price because the specialist is agent for those orders.

In the current market, only Column A exists. If a floor broker enters an order onto the Display Book, it would be executed in price/time priority. Floor broker go along orders are executed in the physical auction, with brokers bidding and offering, and competing with the public limit order book, at each price level.

In the current market, specialists can go along only with floor broker go along orders (not the public limit order book) and only when liquidating a position.

3. Auto Ex Executions Against Display Book Orders (Columns A, B, and C) at the Published Bid and Offer: What the NYSE Has Proposed, and How Such Trading Should Be Conducted

NYSE Rule 72, which by its terms relates to the physical auction, cannot be said to apply to the execution sequencing of orders on the Display Book in response to an incoming auto ex order. Thus, the NYSE has proposed amendments to Rule 70 to provide an order execution schematic in this situation. The rule amendment, by its terms, applies only to execution sequencing at the current bid or offer price. The rule, by its terms, does not address how orders on the Display Book are to be sequenced for execution at a sweep "clean up" price.

The NYSE is proposing the following execution schematic for automated executions at the published bid or offer:

(i) disclosed orders on the display book will be executed before hidden orders;

(ii) floor broker go along orders (Column B) will split executions with orders on the public limit order book (Column A);

(iii) the specialist's order (Column C) will go along with the floor broker go along orders provided there are no orders on the public limit order book (Column A);

(iv) neither the specialist's go along order or any florr broker go along order may claim precedence based on size (the rule is silent as to whether the public limit order book may claim precedence based on size);

(v) hidden orders trade after all disclosed orders have been executed.

There are several aspects of the NYSE's proposal that are welcome:

(i) the display of floor broker go along orders, even if only for 1000 shares, adds a degree of transparency to the market, although the incentive to disclose the order is considerably diluted by the fact that most of the order can remain hidden, with the true depth of the current market remaining non-transparent;

(ii) the execution of disclosed orders ahead of hidden orders is entirely fair and appropriate (and ought to be,but does not appear to be, the model for sweep pricing as well).

That said, there is much that is highly objectionable about other aspects of the execution schematic. Quite simply, the floor broker go along orders are afforded three huge execution advantages over orders on the public limit order book:

(i) Public limit orders entered earlier in time may be denied an execution because of go along orders entered later in time, and entered for the express purpose of superseding the price/time priority of such public limit orders. For example, assume there are two 1000 share public limit orders to buy on the public limit order book. A floor broker, seeing those orders, enters a 1000 share displayed go along order. The go along order and the public limit order book become on parity, with the NYSE's published bid being 3000 shares (2000 shares on the public limit order book, 1000 shares representing the broker's go along order). If a 2000 share order to sell enters the market, the go along order will buy 1000 shares, and the first limit order on the public limit order book will buy the other 1000 shares. The second order on the public limit order book will remain unexecuted, even though it was entered earlier in time than the go along order. If the market then moves away from the order's limit, the order will not be executed at all.

(ii) The NYSE has historically, as well as in this proposal, resolved the fundamental incompatibility between price/time executions and go along executions in the worst possible way. The "parity" rule forces the public limit order book to be treated as only one bidder, regardless of how many orders are actually on the book, the aggregate number of shares represented by those orders, and the times of order entry in relation to the times of order entry of go along orders. Thus, the public limit order book almost always receives inferior "splits" in relation to the number of orders actually on the book, and execution delays, or non-executions, inevitably result.

(iii) Floor brokers enjoy an obvious informational and order entry advantage. They get to see the orders on the public limit order book and can "cherry pick" trading opportunities by entering go along orders whose effect is to supersede the price/time priority of orders on the public limit order book, orders that would otherwise be entitled to those trading opportunites.

There is nothing at all inherently wrongwith go along trading; it is a conventional strategy and should be facilitated in the marketplace, but not at the expense of the public limit order book. The NYSE's outmoded concepts of "parity" and "a trade clears the floor" may have made sense a century or so ago when they were adopted (I've heard different time periods from the NYSE staff over the years) and stocks traded largely by appointment. A former specialist once told me he believed the "parity" rules dated to a time when the NYSE had competing specialists with competing public limit order books. The purpose of "parity" in this context was simply to assure that public limit order books had an equal opportunity to trade, a rationale that hardly obtains today.

At the risk of seeming trite, let me say that the proper execution schematic for the NYSE's proposal really is as simple as ABC. First, the orders on the public limit order book (Column A); then the floor broker go along orders (Column B), which, in the event, are typically public orders; and then the specialist's dealer order (Column C). This preserves fundamental price/time principles, mitigates unfair informational advantages, and is hardly unfair to floor brokers, who always have the option of entering price/time orders. In addition, asserting the primacy of price/time principles will obviously act as a strong incentive for investors to place limit orders on the public limit order book, which will enhance overall market transparency. In fact, the primacy of price/time execution principles will do far more to promote market transparency and the placement of limit orders than the NYSE's proposed 1000 share display requirement for floor broker go along orders at the published bid or offer.

In the event, in today's markets, "parity" is simply a euphemism for "no price/time priority" in active stocks most of the time, a position unknown in any other major securities market. It is common knowledge that the SEC staff has for years disdained the NYSE's "parity" rule, but has felt powerless because the rule was of longstanding. As a new rule is now being proposed, the SEC staff is anything but powerless, and should follow their instincts and protect the public limit order book.

As a fallback (and I trust it won't come to this), if the SEC determines to permit go along orders to supersede the price/time priority of the public limit order book, the SEC must demand (consistent with the specialist's fiduciary duty) that the Display Book be "hard wired" to provide that orders on the public limit order book be executed pursuant to precedence based on size in every instance in which that is possible.

4. Auto Ex Executions Against Display Book Orders (Columns A, B, and C) away from the Published Bid or Offer (Sweeps)

This aspect of the NYSE's proposal is deeply troublesome. While the NYSE has made some effort (though inadequate) to craft a schematic for executions at the published bid or offer, there is no comparable rule for executions at away from the market sweep clean up prices. The NYSE simply states that such transactions will be effected pursuant to Rule 72, a rule which, by its terms, absolutely does not apply, and can not be made to apply absent considerable amendment. It appears that the NYSE is "fudging" it here, attempting to mask the fact that, unlike executions at the published bid or offer, hidden go along orders will in fact split executions with the fully disclosed (through NYSE opened book) public orders on the public limit order book.

Floor broker go along orders that are entered away from the curent market will almost certainly be hidden orders, as, in the cat-and-mouse game of the auction, brokers do not want to "tip their hand." Two significant harms are obvious here:

(i) The price/time priority of the public limit order book, already severely compromised in the conventional floor auction, is further obliterated in sweep transactions, even though the orders on the public limit order book could probably claim time priority as prices changes occur in the NYSE's current floor auction process.

(ii) Floor brokers would be given a particularly unique and unfair advantage over the public. They can see orders on the public limit order book, but investors who have entered, or who are thinking of entering, public limit orders cannot see hidden go along orders, which floor brokers can enter with a kind of "insider" knowledge as to the best prices at which to interact with contra side order flow and supersede (or neuter) the public limit order book's price/time priority. Public investors, unaware of the hidden go along orders, have no opportunity to adjust their limits in response to such hidden orders so as to maximize their opportunities for full and complete executions.

Floor broker go along orders would thus be given a huge and unfair competitive advantage over the public limit order book, which is fully transparent and acts as a "magnet" in attracting contra side liquidity. Once that contra side liquidity is attracted, however, the go along orders function, in effect, as hidden electronic parasites, leeching off of the public limit orders and, by splitting executions at sweep prices, denying complete executions to the very orders that attracted the contra side liquidity in the first place.

This is a manifestly absurd and unfair result, and the SEC should not tolerate it. Or maybe the NYSE should just issue the following disclaimer to the investing public: "Beware. Even though you see the price/time priority of your orders on the public limit order book, hidden orders, that are entered later in time and in reaction to your orders, may well deny you an execution."

Rule 72, as it stands, cannot possibly be relevant to sweep execution pricing. (This will probably not stop the NYSE from issuing one of its infamous "interpretations" that contradict plain rule text. In recent correspondence on SR-NYSE-2004-70, for example, I noted an egregious attempt by the NYSE to rationalize its failure to amend rules clearly impacted by that proposal by concocting an "interpretation" that flew in the face of what the rules actually state). Rule 72 provides for the sequencing of order execution based on bids or offers publicly announced in the auction on behalf of those orders. It cannot (fairly, based on rule text) be interpreted to apply to hidden, away from the market go along orders that have never been publicly displayed.

A hidden go along order on the Display Book is analogous to a floor broker in the auction having an order, but not making a bid or offer on behalf of that order. Since the floor broker did not publicly expose the order, the broker would not be permitted to go along on a trade. And merely entering a go along order on the Display Book can hardly be deemed to be making a "bid" or "offer" in the sense contemplated by Rule 72. There is a significant difference in NYSE rules between an "order", and a "bid" or "offer", which constitute the public representation of an order in the auction. (There is a technical rule drafting error in the NYSE's proposed amendment to Rule 70.10. The NYSE speaks of bids and offers being systemically delivered to the Display Book. It is more accurate, under NYSE rules, to speak of "orders" being delivered. The NYSE means to say in Rule 70.10 simply that automatic execution will occur when an order is delivered to the Display Book that it executable at the current bid or offer price).

In the event, the NYSE proposal is a total mess here. As I noted earlier, the sweep methodology punishes trade initiators in comparison with current rules, largely to the benefit of hidden floor broker go along orders. In addition, it appears that the NYSE is determined to protect displayed interest at the current bid or offer, but reward hidden go along interest at clean up prices, a position that makes no sense whatsoever, except, of course, to cater to floor brokers.

To the extent the SEC permits sweep executions at clean up prices (and it should only be at the option of the trade initiator), the execution schematic should obviously be the same ABC format that should be used for executions at the current bid or offer, so as to mitigate concerns about floor broker advantage over the public limit order book.

5. Rule 108: Specialists' Direct Competition with Public Orders

NYSE Rule 108 is a very significant, long-standing rule governing (principally) the specialist's ability to compete with public orders represented by floor brokers. (NYSE Rule 92 prohibits the specialist from competing with orders on the public limit order book). As relevant to the NYSE's proposal, the rule currently permits the specialist to go along with floor broker orders only when liquidating a dealer position. The historic rationale for this modification of the negative obligation, as was explained to me by the SEC staff, is that it permits the specialist to recapitalise, which has traditionally been viewed as an important aspect of the market making function. The specialist has never been permitted to compete with floor broker go along orders to establish or increase a position, as there is no market making "necessity" for this type of transaction such that public orders should be disadvantaged by direct specialist dealer competition.

The NYSE's position on Rule 108 (in those instances in which it actually acknowledges the rule) defies understanding. Last year, in a stange rule submission that did not even reference Rule 108 or articulate any legal justification whatsover, the NYSE obtained SEC approval for an "opt out" rule to the effect that a customer could refuse to give the specialist permission to go along with the customer's order when the specialist was liquidating a position. In conjunction with its now pending proposal to permit specialists to go along with public orders when acquiring a position, the NYSE is proposing to extend the "opt out" rule to this sort of trading situation as well. These rule changes appeared to signal a degree of predisposition against specialist go along trading. At the same time, however, the NYSE reversed course 180 degrees. Anyone wanting to actually take advantage of the "opt out" rule would be barred from using electronic go along orders, which is the way the NYSE expects most of these orders to be handled. So the NYSE is saying to the investing community, in effect, that it is adopting an "opt out" rule for their protection, but denying them the ability to use it most of the time. I defy anyone to tell me this makes sense, but in the grand scheme of things, this is the least of the NYSE's problems with Rule 108.

In its hybrid market rule submission, the NYSE notes that it will be making a separate submission on Rule 108. As I have not seen it as of this writing, my comments below relate only to what the NYSE has stated in the hybrid market rule submission.

The NYSE offers two reasons for the proposed change to Rule 108, both of which have me shaking my head in despair:

(i) The NYSE claims that the change to Rule 108 would encourage specialists "to add depth and liquidity to the Exchange market by initiating proprietary transactions on the floor of the Exchange."

(ii) The NYSE claims that the change to Rule 108 "comports with existing practice on the floor where brokers may voluntarily allow specialists to be on parity with them."

Point (i) is the sort of meaningless, "make weight" resort to cliches that is engaged in when a party knows that something must be said, but is nonetheless at a loss to come up with anything responsive with respect to the actual considerations under discussion. Allow me to help the NYSE out here. While adding depth and liquidity to the NYSE market, as required, is a critical aspect of the specialist's market making function, the go along trading at issue here is precisely the situation in which that is not needed at all under the negative obligation. The public go along orders against which the specialist would be competing are obviously already supplying the requisite depth and liquidity at that price, at least until they are filled. The only practical effect of the specialist's dealer intervention in a go along situation is to displace the liquidity otherwise being provided by the public go along orders, which receive less of a "fill" than they are entiled to but for the specialist's intervention.

This is exactly why Rule 108 strictly precludes such harmful dealer competition. The need for the specialist to add depth and liquidity obviously arisies only after the go along orders have been satisfied, and there is remaining contra side interest to be filled at that price. This is so obvious that I'm at a loss to believe it needed saying, but it clearly did.

There are at least three major legal issues with respect to specialist parity acquisitions, none of which the NYSE even acknowledges of takes cognisance of in any way:

(i) Such trading, as I note above, is in clear contravention of the negative obligation as set forth in SEC and NYSE rules.

(ii) As was explained to me years ago by an SEC staffer, specialists do not enjoy carte blanche proprietary trading privileges under Section 11(a) of the U.S. Securities Exchange Act. They have an exemption under that law for prorietary trading only when "acting in the capacity of a market maker." Specialist parity acquisitions have never been deemed to be an aspect of the market making function, which is why they have always been precluded. The "market" in this situation is already being made by the go along orders; the specialist is simply elbowing his way into a situation where he is not needed. This is the classic situation where the specialist is simply engaging in proprietary trading, and not acting as a market maker. Per Section 11(a), the specialist must thus yield to public orders, which is exactly what Rule 108 mandates.

(iii) Section 11A of the U.S. Securities Excange Act promotes the objective of public order interaction without dealer intervention. Specialist parity acquisitions constitute a classic example of artificial, forced, unnecessary dealer intervention, and cannot be reconciled with Section 11A.

Bottome line: no matter how one approaches the issue, specialist parity acquisitions are clearly illegal, and should remain so for sound reasons of public policy.

(Before addressing the NYSE's next point, I want to digress and take note of SR-NYSE-2005-40, a seemingly benign but in fact potentially quite dangerous attempt by the NYSE to reward heightened specialist dealer trading in the NYSE's stock allocation system. Specialist parity acquisitions, and the type of specialist algorithmic trading proposed by the NYSE (discussed below), are exactly the sorts of dealer trading that will "puff up" (though quite artificially) the NYSE's self-touted "market quality" statistics. The NYSE is not only, in its rule submission, promoting increased specialist dealer activity, regardless of necessity, but would actually reward it in the stock allocation process. The entire enterprise smacks of an effort to enhance specialist profitability regardless of the need for greater dealer activity. And the NYSE's meaningless, formulaic assertions about trading having to be conducted in accordance with its rules offer no comfort at all, as the NYSE's infamous "trading floor sensitive" rule interpretations (see the SEC settlement orders with the NYSE in both the floor broker and specialist trading scandals) seem to permit the trading floor to often run amuck. Market professionals tend to discount the NYSE's market quality statistics on depth, price continuity, etc. because they are easily manipulable by specialists, who can make themselves and their markets look good with meaningless in-and-out dealer-turn trading at and within the current bid and offer, but who fade from view in potential price dislocation situations, where they are really needed (classic "lies, damn lies, and statistics"). The SEC needs to take a very hard look indeed at SR-NYSE-2005-40).

In recent correspondence on SR-NYSE-2004-70, I felt compelled, out of sheer exasperation, to use the term "moronic drivel" to describe a logic-and-common-sense-defying explanation by the NYSE as to how its auction actually works. But, in context, the NYSE's ignorance there was relatively harmless. The same cannot be said of the NYSE's truly astonishing second point with respect to Rule 108.

The NYSE maintains that specialist parity acquisitions should be permitted to "comport with existing practice on the floor where brokers may voluntarily allow specialists to be on parity with them." Let me try to piece together "NYSE logic" here: although Rule 108 clearly makes specialist parity acquisitions illegal, floor brokers are apparently authorized to give specialists permission to engage in illegal trading, and specialists may accept that permission and violate the law, superseding floor broker public orders. But, says the NYSE, why quibble about legal technicalities, much less the public interest. Let's just make everything legal anyway ("comport with existing practice"), and let's not burden the over-worked SEC staff by even mentioning the law (much less its purpose) in the first place.

Hard to believe, but this is not really an unfair characterisation of the NYSE's position.

Let me start with the obvious: in the face of a strict regulatory prohibition, no one (much less a floor broker, of all people!!!) is empowered to simply grant ad hoc dispensations. It is not the floor broker's prerogative to "waive" a strict prohibition intended to protect the broker's own customers (who, of course, know nothing of the waiver). And it is hardly the specialist's prerogative to accept that "waiver" and siphon executions away from the public. There is nothing in Rule 108 that even remotely suggests the rule could be construed to permit such "waivers." Rule 108 is a simple, long-standing public order protection rule. Floor traders cannot "waive" the protection of the public. It really is that simple. Regardless of what "parity accommodations" floor brokers may make among themselves (and there are clear fiduciary duty implications when they do make such accommodations), they clearly cannot make such accommodations to specialists in the face of a clear-cut regulatory bar grounded in sound public policy.

The prohibition in Rule 108 serves an important public purpose: the execution of public orders without artificial, unnecessary dealer competition. Floor brokers who purport to allow such dealer competition are obviously breaching fiduciary duties to their customers, because the quality of public order execution is diluted to the extent of the unnecessay dealer intervention.

The ultimate problem here is obvious: collusion among trading floor participants, with the NYSE itself blessing the whole mess. The NYSE acknowledges this collusiveness in the very terminology it uses. There is a plain English translation readily available to describe a situation in which "existing practices" do not "comport" with existing rules: the "existing practices" are illegal. How can it possibly be that the NYSE's response when it sees practices not in conformity with its rules is not to immediately take stringent regulatory action to protect the public interest? But that's not how the NYSE works, as confirmed in the SEC's two settlement orders with the NYSE, which describe how the NYSE "interprets" its rules in a manner that advantages the trading floor to the detriment of the public. And so, and in business-as-usual as I noted earlier, specialist's routinely breach their fiduciary duty to the public limit order book by failing to assert precedence based on size to ensure that the orders on the book receive a timely and complete execution. As recompense for not "embarrassing" them, floor brokers "give permission" for the specialist dealer account to compete directly with their public customers. The trading floor "protects" itself (its overriding concern) and the public interest is compromised, while the NYSE marketing machine babbles on about the "expertise" and "professional judgment" of its floor community.

I can assure the NYSE that the professional trading community knows exactly how the floor works, and has more than had its fill.

Yes, changing Rule 108 to "comport with existing practice" is one possible approach.

Let me suggest an alternative approach. Perhaps the SEC's Office of Compliance and Inspections (OCIE) might consider taking the following actions:

(i) review the NYSE's surveillance of Rule 108 and demand that the NYSE enforce the rule;

(ii) demand that the NYSE take regulatory action against specialists who have violated Rule 108;

(iii) demand that the NYSE take regulatory action against specialists who have breached fiduciary duties by not asserting precedence based on size to protect limit orders entrusted to their care;

(iv) demand that the NYSE take regulatory action against floor brokers who have "given permission" and thus aided and abetted the specialists' violations of Rule 108, while at the same time breaching their fiduciary duties to their customers.

And what of the NYSE itself in all this? Notwithstanding two SEC enforcement actions that noted, among other matters, serious "rule interpretation" problems, the NYSE apparently still doesn't get it. It is shocking that the NYSE could talk about "comporting with existing practice" with utter disregard to the fact that these "existing practices" have been clearly illegal for years and are clearly damaging to the public. The NYSE's absolute indifference to Rule 108 is demonstrated by the fact that, until this amendment to its proposal (and then only in response to my earlier comments), the NYSE (incredibly) had not even mentioned Rule 108, much less proposed to amend it, even as it was advocating specialist parity acquisitions that are forbidden by the rule. I don't know whether people at the NYSE were just asleep at the switch (it doesn't appear to me that the NYSE's lawyers review its rule submissions these days) or whether there was a conscious effort to keep the SEC and the public in the dark. Regardless, either answer undermines the investing community's confidence in the ability of the NYSE to enforce its rules in the public interest.

Clearly, OCIE needs to have a very serious discussion with the NYSE.

6. The NYSE's Proposed Exposure of "Auction" Market and Limit Orders for "Price Improvement" Will Likely Result in Inferior Executions, or No Executions At All

In my earlier correspondence, I noted that the NYSE's proposed order exposure/price improvement methodology for "auction" (a counter-intuitive term as used by the NYSE) market and limit orders is inconsistent with the long-established principles of NYSE Rules 76 and 91, which prescribe a time-tested methodology that has proven very effective in providing price improvement to investors. The NYSE has proposed an alternative procedure, but, in its typical fashion, has not even acknowledged or proposed to amend Rules 76 and 91, which are otherwise applicable to the exposure of orders for price improvement. As my earlier discussion was somewhat lengthy, I will not repeat it here, but I ask that it be incorporated by reference herein, as it is highly significant.

Price improvement resulting from genuine order competition in the auction (which is distinguishable from the bogus "price improvement" on offer in the proposed specialist algorithm market, as I demonstrate below) has long been a great strength of the NYSE. The NYSE's statistics suggest that some 40 percent or so of orders eligible for price improvement in fact receive it, a benefit to the public of hundreds of millions of dollars a year. The NYSE's proposed 15 second exposure procedure, with an entirely different schematic from that which has proven so effective in Rules 76 and 91, is likely to result in less price improvement, pricing that is inferior to that which exists in the market when the order is received (a result that cannot happen under current rules, and is unknown in other markets), and a greater prospect of orders not even being executed. Given the prospect of inferior pricing, the NYSE proposal effectively gives the specialist an illegal "not held" order, and renders it virtually imposssible for broker-dealers with "best execution" responsibilities to seek price improvement on the NYSE. (All of this is demonstrated in my earlier correspondence).

The SEC must demand that the NYSE justify the radical changes it is proposing, changes that appear likely to have a significant, negative financial impact on the investing community, given the large economic value of price improvement currently available on the NYSE.

SPECIALISTS' ALGORITHMIC TRADING: AN IDEA WHOSE TIME DEFINITELY HAS NOT COME

The NYSE is proposing to allow specialists (and only specialists) to use "algorithms" (pre-programmed computer applications that "read" incoming systemic order flow and generate quotes, orders, and engage in proprietary trading in response to what they "read"). The NYSE has made allusions (no actual proposal yet) to permitting floor brokers to engage in algorithmic trading by means of a new "discretionary" order, a concept that strikes me, preliminarily, has particularly horrendous, as it is likely to lead to a resurgence of spread-capture trading, which was at the heart of the floor broker trading scandal several years ago.

The algorithmic proposal is deficient as a matter of law, provides the specialist with a virtual "license to print money" in cyberspace with no net public economic benefit, permits the specialist to trade ahead of his public customers, and allows the specialist to engage in a unique form of insider trading to the particular detriment of the public limit order book. Except for the ability to quote via algorithm, the SEC must reject this aspect of the NYSE's proposal out of hand. My earlier correspondence continues to be largely relevant here, in addition to the specific points I make below.

1. The NYSE Proposal Violates the Negative Obligation By Providing A Specialist Trading Monopoly

In my earlier correspondence, I indicated that the NYSE needed to propose for public comment a detailed, specific amendment to the negative obligation. The NYSE has singularly failed to do so, nor has it provided any justification whatsoever for the algorithmic monopoly it would grant the specialist. This fact alone makes the NYSE's proposal an absolute non-starter for reasons of fair competition and equal access to markets. The NYSE can dream up all the "bells and whistles" it wants as purported restraints on what the specialist can do, but it is missing the essential point. The threshold issue that the NYSE needs to address (and that the SEC needs to resolve, which it certainly cannot in a way that is favorable to the NYSE here) is not about what conditions are appropriate, but why it is that an exclusive opportunity is being given to the specialist in the first place.

The NYSE's proposal turns the negative obligation on its head and would permit the specialist, by law and rule the trader of last resort, to front run the entire market, a total distortion of the specialist's historic role.

Algorithmic trading is a promising aspect of a genuine hybrid market. But it has to be made available to all market participants on reasonably equal terms, rather than being made available to only one market participant on privileged terms. The fatal defect here for the NYSE is that by law the specialist has to go at the end of the queue, rather than be allowed to be the only one in the queue to begin with.

2. The "Price Improvement" to Be Provided Is a Sham

The NYSE is proposing to permit the specialist to engage in algorithmic "price improvement" in two ways:

(i) The specialist's algorithm may generate an order to trade with orders entering the market that will enter the Display Book, but an unspecified period of time must elapse, before the specialist's order is executed, so that the market generally can become aware of and react to the order.

(ii) The specialist's algorithm may generate an order to electronically intercept an incoming auto ex order that would otherwise be automatically executed against the contra side bid or offer.

I shall confine my comments principally to (ii). With respect to (i), the unspecified time period should obviously be spelled out in the applicable rule, and should be at least as long as the 15 seconds that "auction" limit and market orders may have to wait before being executed.

With respect to (i) and (ii), the algorithm has access to certain market information, including information about public orders on the public limit order book. The algorithm does not have access to information about floor broker go along orders, either individually or in the aggregate. The algorithm can "layer" (English translation: enter) specialist dealer orders at various prices onto the Display Book as incoming orders enter NYSE systems.

Algorithmic "price improvement" is subject to the following conditions:

(i) the specialist must be "represented" in the bid if buying and the offer if selling;

(ii) where the quotation spread is three to five cents, the "price improvement" must be at least two cents;

(III) where the quotation spread is more than five cents, "price improvement" must be at least three cents;

(iv) where the quotation spread is two cents, "price improvement" must be at least a penny ("penny jumping").

While the NYSE's conditions are an attempt to make the proposal appear reasonable, they are clearly meaningless once when steps back and considers how specialists actually make money. (I'm grateful for some input from two former specialists here).

As my two teenage sons would say, let's get real here. Specialists engage, for the most part, in in-and-out dealer-turn trading at or within the current quotation, buying on the bid side of the market and selling on the offer side of the market. Quoted markets frequently straddle the last sale, so "stablization" requirements are no inhibition at all. While risk can never be eliminated, specialists operate most often under a risk-reduced dynamic, a large factor in their historically stratospheric rates of return on capital, rates virtually unknown in any other part of the securities industry. Last I checked, specialists were not required to take a vow of poverty. They are singularly aggressive "business" people at the point of sale, and when they provide "price improvement" it is not out of the goodness of their hearts. "Price improvement" is the incidental by-product, typically, of the specialists' seizure of dealer-turn trading opportunities, where the specialist buys slightly above the bid and turns around and sells slightly below the offer, locking in an easy profit.

With respect to "price improvement" in the context of the electronic interception of auto ex orders, it is reasonable to assume (since specialists are astute at making money) that the algorithm will be programmed to act only in what are likely to be profitable opportunites for the specialist, and will not act when it is against the specialist's economic interest.

The absolutely crucial factor to consider here is whether the specialist is providing a genuinely improved price with no adverse economic impact on other market participants, or whether the specialist is simply engaging in dealer-turn trading with no net public benefit.

The NYSE gives the game away with its "fudged" reference to the specialist merely having to be "represented" in the published bid if buying, and the offer if selling. It is likely that the algorithm will be used only when the specialist is "represented" in the published bid or offer, but is not the priority bid or offer. Under NYSE rules, the specialist can presumably be "represented" in the bid or offer for a token 100 shares, which the algorithm, with its ability to "read" the public limit order book, will surely add on (consider it the "price of admission" to the game).

The examples below describe likely algorithmic "price improvement" scenarios.

(i) Specialist Priority Bid and Priority Offer: No "Price Improvement"

Assume the specialist's priority bid is .50 and the specialist's priority offer is .55. An incoming auto ex order to sell will simply be automatically executed against the published bid at .50, with no price improvement being afforded. The reason is obvious: since the specialist can buy at .50, he will not "out bid" himself by paying more for the stock. The specialist will want to "flip" the stock for a quick dealer turn against an incoming auto ex order to buy, locking in a five cent profit. Should such an order enter NYSE systems, it will be automatically executed against the published offer of .55. No "price improvement" is afforded, because the specialist, who can sell at .55, will not "out offer" himself and sell for less. While it's a great business to be in, it cannot be said that the specialist has an unfair advantage here, because the trades take place at "sunlight" published prices, the public can see these prices and is free to compete, and the specialist is not denying an execution to an order on the public limit order book.

(ii) Public Priority Bid/Specialist's Priority Offer: "Price Improvement" Only to a Sell Order

Assume that the public limit order book has a priority bid of .50, and the specialist has the priority offer of .55. If an auto ex sell order enters NYSE systems, the algorithm will provide "price improvement" by buying the stock at.52 (the NYSE's proposed price parameter applicable here), denying an execution to the priority bid being made on behalf of the public limit order book. The specialist will then seek to to "flip" the stock out by selling it at his priority offer of .55 should an auto ex order to buy enter the system. No "price improvement" would be afforded to such an auto ex buy order, as the specialist will not "out offer" himself and thereby reduce his profit.

(iii) Public Priority Bid/ Public Priority Offer: "Price Improvement" to Buy and Sell Orders

Assume the published quotation is .50 bid - .55 offer, both on behalf of the public limit order book. The algorithm will intercept an incoming auto ex order to sell by providing "price improvement" at .52 and will intercept an incoming auto ex order to buy by "flipping" the stock and providing "price improvement" at .53, profiting the specialist, but completely shutting out the public limit order book on both sides of the market.

Obviously, market "nuances" suggest variables that would modify these examples in particular trading situations, and the ability to "flip", while reasonably likely in active stocks with two-way order flow, cannot be guaranteed, etc. But this is clearly the basic framework within which the algorithm would seek to operate.

The only real effect of the NYSE's proposed price parameters is to limit somewhat the amount of money the specialist can make, but specialists can easily live with that because the trade-off is so favorable: a risk-reduced environment with cherry-picked "no brainer" profits and no auction market "fishbowl" to discipline the process, all courtesy of their new best friend, Al Gorithm.

But what about the orders that received "price improvement"? Isn't that a public benefit sufficient to allow the specialist to be granted this exclusive, private license to print money? Hardly. Even in the physical auction, "price improvement" is a zero sum game, with the order getting the improved price shutting out another order that would otherwise get to trade. But at least, when that happens, it is often the result of genuine order competition in an open outcry auction, so there is a degree of fairness that can be verified by other market participants at the point of sale.

In contrast, the specialist's money printing facility engenders the zero sum game to end all zero sum games. The NYSE is proposing to grant the specialists a hidden, electronic "heads-I-win, tails-you-lose" monopoly, with every penny of "price improvement" coming at the expense of the public limit orders, which are denied executions in a schematic involving no public "sunshine" whatsoever.

Net public benefit: zero. In fact, there is a significant harm here, because it disincents the placement of public limit orders on the public limit order book. Net specialist benefit: easily in excess of the fines they had to pay to settle the recent SEC enforcement action against them. (Is this the way the NYSE is proposing to "make it up" to them?).

Sorry, NYSE. This just doesn't pass the smell test.

The SEC cannot possibly find that this sham is in the public interest.

3. By Permitting Specialists to Trade Ahead of Their Public Customers, the Algorithmic Proposal Can Only Further Undermine Public Confidence in the Integrity of the NYSE

Despite the recent scandal involving specialist trading ahead of their customers, the NYSE is actually proposing to amend Rule 92 to let them trade ahead of customers in situations where the algorithm has generated a specialist order, but before the order is executed, a public order is entered that should otherwise displace the specialist. In the physical auction, a specialist may well have made a mental decision to trade, and be on the verge of trading, but if a public order arrives the specialist must give way. The algorithm market should work the same way. Regardless of the "tight" timeframes involved, the NYSE needs to program this (and I can't believe that it isn't programable) so that a specialist's dealer order can never be executed ahead of a public order, executable at the price of the proposed specialist trade, that is accepted into NYSE systems before the specialist's trade is completed.

The general investing public will never understand the algorithm market. But they will well understand that a hidden algorithm can advantage the specialist in a way that the specialist could not advantage himself in the physical auction.

The proposed amendment to Rule 92 can only undermine confidence in the NYSE market, is not in the public interest, and should not be approved by the SEC.

4. The NYSE Proposal Would Permit the Specialist to Engage in Insider Trading Based on Material, Nonpublic Market Information

There is a huge danger in creating a market in which the specialist's algorithm (knowledge obviously imputed to the specialist) has access to material market information available to no other market participant. Regardless of the NYSE's "bells and whistles", the perception problem alone should make the proposal a non-starter because of its adverse impact on the public's confidence that all market participants are treated in a fundamentally fair and even-handed way.

The NYSE has shown a degree of sensitivity to the insider trading problem in the types of restraints it would put on the ability of the algorithm to generate a message to trade in response to its knowledge of incoming orders. But the specialist still has a huge advantage here in being pre-programmed to act systemically while other market participants, who receive the information after the algorithm has acted or positioned itself to act, may either have to react through manual processes, or automated processes that lack the sophistication and intimate connection to NYSE systems enjoyed by the algorithm. There are serious smell test problems here, and the potential for scandal/loss of confidence in the NYSE market more than offsets any possible public benefits (and I'm clueless about what they might be in any case) the NYSE thinks is derived from giving the specialist unique monopoly privileges.

But there is one aspect of the proposal that is particularly troubling, as it appears to allow for clearly illegal insider trading. The algorithm can "read" incoming orders as they enter NYSE systems, and can enter specialist dealer orders into the Display Book at away from the market prices in response to acquiring this information. Furthermore, the algorithm, with its knowledge of the public order book, can determine the most favorable prices at which to enter orders into the Display Book in relation to where the public orders are priced. The algorithm clearly has nonpublic information about the incoming order, and the materiality of that information is manifest in the fact that the algorithm enters orders in response to the information. If the incoming order is a sweep order, the algorithm can "read" the size of the order, determine a likely clean up price, and advantageously place a dealer order on the Display Book, at let's say a penny better than where public limit orders would otherwise be cleaned up. The algorithm then obtains a clean up price premium or discount for the specialist, effectively shutting out the public limit order book, which, but for the algorithm, would have obtained such premium or discount. By any standard, this is illegal insider trading.

The NYSE has attempted to preclude the algorithm from generating a message to trade in obvious insider trading situations, meaning that the algorithm cannot proactively initiate a trade, what one might call "active" insider trading. But in my example, no message to trade need be generated. The offensive act is the advantageous placement of the dealer order based on material, nonpublic information. The sweep protocol will execute the order (the algorithm will not generate a message to trade), allowing the specialist to engage in "passive" insider trading, with the public being left completely in the dark.

A deeply disturbing aspect of the NYSE's proposal, but one totally on track with the NYSE's consistent favoritism toward trading floor interests, is the fact that the algorithm does not have information about floor broker go along orders. In other words, the algorithm can place dealer orders on the Display Book that may disadvantage the public limit order book (say by "pennying") but cannot take a similar action that might disadvantage the specialist's good buddy, the floor broker. Hard to believe the NYSE itself would stoop so low. Beyond outrageous.

Not that the SEC should allow any of this monopolistic algorithmic nonsense in the first place, but the ability of the algorithm to place dealer orders on the Display Book absolutely must be deleted from the proposal.

THE NYSE MUST ADDRESS THE SERIOUS LEGAL DEFICIENCIES IN ITS PROPOSAL

Without in any way acknowledging that it is doing so, much less providing any justification whatsoever, the NYSE is proposing a radical revision of four fundamental pillars of its market:

(i) the NYSE's algorithmic proposal renders meaningless the negative obligation;

(ii) the proposed pricing of "auction" market and limit orders is radically different from the fundamental order exposure/price improvement principles of Rules 76 and 91, which are fundamental bedrocks as to how the NYSE functions;

(iii) the proposed sweep pricing methodolgy transforms the economics of large-size order execution to the detriment of off-floor trade initiators;

(iv) the proposed amendment to Rule 108 would allow specialists to compete directly with public order in situations where they have always been precluded from doing so.

I have discussed these matters at length previously. My point here is simply to say that these are profound changes, and the NYSE has given no more thought to justifying them than someone would give to swatting a fly away at a picnic, which appears to be the NYSE's exact attitude toward any longstanding rules that might be "inconvenient" to what it wants to do. I'm not necessarily arguing that these rules should be retained, or that they can't be changed. But there is a fundamental legal process involved here that the NYSE appears no longer to respect. By proposing such fundamental changes, the NYSE has assumed the "burden of proof" in justifying them, and the public is entitled to reasoned legal analysis and rationale, so that it may comment intelligently not only about the NYSE's technical details, but about its reasoning as well. That is the way the SEC's process (the best in the world, by far) is supposed to work.

With respect to the four items noted above, the NYSE simply ignores the underlying issues, and doesn't even bother proposing rule amendments where they are clearly required. It makes no effort whatsoever to relate its algorithmic proposal to the negative obligation. There isn't even any mention of Rules 76 and 91, much less a reasoned justification as to why the time-tested methodology of those rules, which has led, over the years, to probably billions of dollars in price improvement, is being abandoned. There is no acknowledgment whatsoever of the significant adverse economic impact on the off floor trading community of its proposed sweep methodology, much less a justification for this transformation. And the NYSE's treatment of Rule 108 simply demonstrates an ignorance of its own rules that is truly disheartening. One wonders how the NYSE can enforce its own rules when it doesn't even understand them.

There is something seriously wrong here in the NYSE's approach to the rule submission process. Its jargon-encrusted exposition frustrates basic comprehension, and its meaningless conclusory assertions about promoting fair and orderly markets are hardly a substitute for legal reasoning.

This is not a trivial matter, and the SEC staff needs to confront the NYSE on this.

However one wants to argue about the merits of details in the NYSE's proposal, one point is inarguable: the NYSE's rule submission is seriously deficient as a matter of law, and these deficiencies must be addressed. This rule submission can by no means be deemed to be in its final form.

WHAT THE NYSE SHOULD DO

There are aspects of the NYSE's proposal that are clearly in the public interest, and could probably be implemented wiithin a reasonable time frame. The NYSE should simply abandon its delusional, deceptive pretensions about a "hybrid market", stop catering to its trading floor at the expense of the public interest, and implement the following:

(i) remove order entry size restrictions in the Direct system;

(ii) permit sweeps, but leave the pricing methodolgy to the option of the trade initiator;

(iii) permit floor broker go along orders and specialist dealer orders to be entered into the Display Book, but subject to the ABC pricing schematic I discussed, to promote fundamental fairness and incent the placement of limit orders on the Display Book;

(iv) remove the artifical restraints on order entry that result in "forced intermediation" and needless expense.

CONCLUSION

All SRO rule submissions are self-serving to some extent, but few, if any, are ever as nakedly self-serving as this one. But over the years I have developed great confidence in the honour, integrity, and intelligence of the SEC staff. You are truly the investing public's "last line of defense" against the predatory instincts of those who purport to serve the public, but, being "business" people, are first and foremost seeking proprietary advantage regardless of how they cloak their "good intentions."

I urge the SEC staff to stand up to the NYSE marketing machine, which is continually suggesting that this semi-abomination is a "done deal." In reality, the NYSE still has a great deal of work to do before this proposal can be said to serve the public interest.

Sincerely yours,

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