

proposes to adopt a \$4,000 fee for aggrieved parties requesting review by a hearing panel. In addition, aggrieved parties that seek review of the hearing panel's decision would also be subject to an additional \$4,000 fee.

The proposed rule change will be effective immediately upon Commission approval.

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(5) of the Act, which requires, among other things, that NASD rules provide for the equitable allocation of reasonable dues, fees and other charges among members and issuers and other persons using any facility or system that NASD operates or controls. NASD also believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change will clarify the OTCBB eligibility review process and will impose certain fees associated therewith to compensate NASD for the costs of conducting eligibility review hearings.

### *B. Self-Regulatory Organization's Statement on Burden on Competition*

NASD does not believe that the proposed rule change, as amended, will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments were neither solicited nor received by NASD.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change, as amended, or

(B) Institute proceedings to determine whether the proposed rule change, as amended, should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2005-067 on the subject line.

### *Paper Comments*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2005-067. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2005-067 and should be submitted on or before April 21, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

Nancy M. Morris,  
Secretary.

[FR Doc. E6-4673 Filed 3-30-06; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-53539; File No. SR-NYSE-2004-05]

### Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change and Amendment Nos. 1, 2, 3, and 5 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 6, 7, and 8 to the Proposed Rule Change to Establish the Hybrid Market

March 22, 2006.

#### I. Introduction

#### II. Description of the Proposal

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1. Automated Access to Display Book System
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3. Autoquote
4. Automatic Executions
  - (a) Priority, Parity, and Precedence
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- B. Role of the Specialists in the Hybrid Market

##### 1. Specialist Algorithms

- (a) Quoting Messages
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  - (1) Specialists' Ability to Systematically Price Improve Incoming Orders
  - (2) Specialists' Ability to Hit Bids or Take Offers
2. Limitations on Members' Trading Because of Customers' Orders—NYSE Rule 92

##### 3. Policy for Communicating with the Specialist Algorithm

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2. Record of Orders/Order Tracking
3. NYSE Rule 91
- F. Hybrid Market Implementation Plan
  1. Phase 1—Floor Broker Agency Interest Files, Specialist Interest Files, and Systematic Integration of Priority, Parity, and Yielding Requirements

<sup>20</sup> 17 CFR 200.30-3(a)(12).

2. Phase 2—API and Specialist Algorithms
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- G. Limited Hybrid Market Pilot

### III. Summary of Comments and NYSE’s Response

#### A. Liquidity Available for Automatic Executions

##### 1. Specialist Interest File and Specialist Reserve

###### (a) Specialists’ Parity

##### 2. Floor Broker Agency Interest Files and Reserve

#### B. Automatic Executions

##### 1. Sweeping the Display Book System

##### 2. Automated Routing to Other Markets

#### C. Availability of Direct+ and Liquidity Replenishment Points

#### D. Role of the Specialist in the Hybrid Market

##### 1. Specialist Algorithm

##### 2. Specialists’ Ability to Systematically Price Improve Incoming Orders

#### E. Auction Limit and Auction Market Orders

### IV. Discussion

#### A. Increased Access to Display Book System

##### 1. Liquidity Replenishment Points

#### B. Autoquote

#### C. Liquidity Available for Automatic Execution

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#### E. Role of Specialist in the Hybrid Market

##### 1. Price Improvement

##### 2. Ability to Hit Bids or Take Offers

##### 3. NYSE Rule 92

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#### F. Changes to the Auction Market and New Order Types

#### G. Intermarket Sweep Order

#### H. Implementation Plan

#### I. Interpretive Issues

### V. Accelerated Approval of Amendment Nos. 6, 7, and 8

### VI. Solicitation of Comments on Amendment Nos. 6, 7, and 8

### VII. Conclusion

## I. Introduction

On February 9, 2004, the New York Stock Exchange LLC (“NYSE” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b–4 thereunder,<sup>2</sup> a proposed rule change to create a “Hybrid Market” by, among other things, increasing the availability of automatic executions in its existing automatic execution facility, NYSE Direct+® (“Direct+”), and providing a

means for participation in the expanded automated market by its floor members.

On August 2, 2004, NYSE filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission published the proposed rule change, as amended by Amendment No. 1, for comment in the **Federal Register** on August 16, 2004.<sup>4</sup> On August 26, 2004, the Commission extended the public comment period with respect to the First Notice to September 22, 2004.<sup>5</sup> In response to the First Notice, the Commission received 17 comment letters from 15 commenters.<sup>6</sup>

On November 8, 2004 and November 9, 2004, the Exchange filed Amendment Nos. 2 and 3, respectively.<sup>7</sup> The Commission published the proposed rule change, as further amended by Amendment Nos. 2 and 3, for comment in the **Federal Register** on November 22,

<sup>3</sup> See Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated July 30, 2004, and accompanying Form 19b–4, which replaced the original filing in its entirety (“Amendment No. 1”).

<sup>4</sup> See Securities Exchange Act Release No. 50173 (August 10, 2004), 69 FR 50407 (“First Notice”).

<sup>5</sup> See Securities Exchange Act Release No. 50277, 69 FR 53759 (September 2, 2004).

<sup>6</sup> See Letters from Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company, dated August 10, 2004 (“Fidelity Letter I”); James L. Rothenberg, Esq., dated August 20, 2004 (“Rothenberg Letter”); Donald E. Weeden, dated August 31, 2004 (“Weeden Letter”); Thomas Peterffy, Chairman, and David M. Battan, Vice President, Interactive Brokers Group, dated September 7, 2004 (“IBG Letter I”); Jose L. Marques, PhD, Managing Member, Telic Management LLC, dated September 21, 2004 (“Telic Letter”); Junius W. Peake, Monfort Distinguished Professor of Finance, Kenneth W. Monfort College of Business, University of Northern Colorado, dated September 22, 2004 (“Peake Letter I”); Ari Burstein, Associate Counsel, Investment Company Institute, dated September 22, 2004 (“ICI Letter I”); Kim Bang, President and Chief Executive Officer, Bloomberg Tradebook LLC, dated September 22, 2004 (“Bloomberg Letter I”); Ellen L.S. Koplow, Executive Vice President and General Counsel, Ameritrade, Inc., dated September 22, 2004 (“Ameritrade Letter”); Lisa M. Utasi, President, and Kimberly Unger, Executive Director, The Security Traders Association of New York, Inc., dated September 22, 2004 (“STANY Letter”); George W. Mann Jr., EVP & General Counsel, Boston Stock Exchange, dated September 22, 2004 (“BSE Letter”); Bruce Lisman, Bear, Stearns & Co. Inc., dated September 28, 2004 (“Bear Stearns Letter”); Donald D. Kittell, Executive Vice President, Securities Industry Association, dated October 1, 2004 (“SIA Letter I”); Edward J. Nicoll, Chief Executive Officer, Instinet Group, dated October 25, 2004 (“Instinet Letter”); Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company, dated October 26, 2004 (“Fidelity Letter II”); Philip Angelides, Treasurer, State of California, dated November 23, 2004 (“Angelides Letter”); and Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Company, dated December 8, 2004 (“Fidelity Letter III”).

<sup>7</sup> See Form 19b–4 dated November 8, 2004 (“Amendment No. 2”) and Partial Amendment dated November 9, 2004 (“Amendment No. 3”).

2004.<sup>8</sup> In response to the Second Notice, the Commission received nine comment letters from eight commenters.<sup>9</sup>

On June 17, 2005, the Exchange filed Amendment No. 5 to the proposed rule change.<sup>10</sup> The Commission published the proposed rule change, as further amended by Amendment No. 5, for comment in the **Federal Register** on June 29, 2005.<sup>11</sup> In response to the Third Notice, the Commission received six comment letters.<sup>12</sup>

In total, the Commission received 43 comment letters on the amended proposal (including 32 comment letters with respect to the First, Second, and Third Notices).<sup>13</sup> On September 21,

<sup>8</sup> See Securities Exchange Act Release No. 50667 (November 15, 2004), 69 FR 67980 (“Second Notice”).

<sup>9</sup> See Letters from Gregory van Kipnis, Managing Partner, Invictus Partners, LLC, dated December 10, 2004 (“Invictus Letter”); Ari Burstein, Associate Counsel, Investment Company Institute, dated December 13, 2004 (“ICI Letter II”); Ann L. Vlcek, Vice President and Associate General Counsel, Securities Industry Association, dated December 13, 2004 (“SIA Letter II”); Thomas Peterffy, Chairman, and David M. Battan, Vice President, Interactive Brokers Group, dated December 14, 2004 (“IBG Letter II”); William R. Power, Member and Director, Chicago Board Options Exchange, Incorporated, dated December 21, 2004 (“Power Letter”); Marc L. Lipson, Associate Professor, Terry College of Business, The University of Georgia, dated January 4, 2005 (“Lipson Letter”); Edward S. Knight, The Nasdaq Stock Market, dated January 26, 2005 (“Nasdaq Letter”); and George Rutherford, Consultant, dated March 10, 2005 (“Rutherford Letter I”) and April 8, 2005 (“Rutherford Letter II”).

<sup>10</sup> See Form 19b–4 dated June 17, 2005 (“Amendment No. 5”). The Exchange submitted Amendment No. 4 to the proposed rule change on May 25, 2005, and subsequently withdrew Amendment No. 4 on June 17, 2005.

<sup>11</sup> See Securities Exchange Act Release No. 51906 (June 22, 2005), 70 FR 37463 (“Third Notice”).

<sup>12</sup> See Letters from George U. Sauter, Managing Director, The Vanguard Group, Inc., dated July 20, 2005 (“Vanguard Letter”); Ari Burstein, Associate Counsel, Investment Company Institute, dated July 20, 2005 (“ICI Letter III”); Donald D. Kittell, Executive Vice President, Securities Industry Association, dated July 20, 2005 (“SIA Letter III”); George Rutherford, Consultant, dated July 20, 2005 (“Rutherford Letter III”); Kim Bang, President and Chief Executive Officer, Bloomberg Tradebook LLC, dated July 28, 2005 (“Bloomberg Letter II”); and Frank A. Torino, dated September 27, 2005 (“Torino Letter”).

<sup>13</sup> See *supra* notes 6, 9, and 10. The Commission received a comment letter on Amendment No. 4, which was withdrawn by the Exchange. See Letter from Junius W. Peake, Monfort Distinguished Professor of Finance, Kenneth W. Monfort College of Business, University of Northern Colorado, dated June 17, 2005 (“Peake Letter II”). In addition, the Commission received three comment letters from the same commenter in response to Amendment Nos. 6 and 7. See Letters from George Rutherford, Consultant, dated November 1, 2005 (“Rutherford Letter IV”), November 8, 2005 (“Rutherford Letter V”), and November 17, 2005 (“Rutherford Letter VI”). Finally, the Commission received seven other comment letters from two commenters. See Letters from Warren P. Meyers, President, Independent Broker Action Committee, Inc., dated December 7, 2005 (“IBAC Letter I”), February 2, 2006 (“IBAC Letter II”), and March 17, 2006 (“IBAC Letter III”),

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b–4.

2005, the Exchange filed a response to the comment letters.<sup>14</sup>

On September 16, 2005, the Exchange filed Amendment No. 6 to the proposed rule change.<sup>15</sup> In Amendment No. 6, the Exchange proposes to amend NYSE Rule 104 to state that specialists may only provide price improvement to incoming orders that are marketable. In addition, NYSE proposes to amend NYSE Rule 70.20 to limit the ability of interest in the floor broker agency interest file to trade on parity with orders in the customer limit order display book ("Book") during a sweep.

On October 11, 2005, the Exchange filed Amendment No. 7 to the proposed rule change.<sup>16</sup> In Amendment No. 7, the Exchange made non-substantive stylistic, conforming, and technical changes to certain Exchange rules governing the Hybrid Market. In Amendment No. 7, the Exchange also proposes to amend NYSE Rule 92 to reflect the operation of the specialist systems that employ algorithms to generate quoting and trading messages ("Specialist Algorithms"). Specifically, the Exchange proposes that the specialist would not be deemed to have "knowledge" of a particular incoming order that is viewed by the Specialist Algorithm if the Specialist Algorithm is designed in a manner that prevents a quoting or trading message from being affected by a later incoming order. In addition, NYSE proposes in Amendment No. 7 to amend NYSE Rule 13.30 and the definitions of stop and stop limit orders to reflect the automatic execution of elected stop and stop limit orders in the Display Book system.<sup>17</sup>

On March 14, 2006, the Exchange filed Amendment No. 8<sup>18</sup> to the

proposed rule change. In Amendment No. 8, NYSE proposes to: (1) Amend proposed NYSE Rules 13 and 124 to specify that a round lot portion of a part of round lot ("PRL") order is an "Auto Ex Order"<sup>19</sup> and that the odd lot portion of a PRL order would be executed at the same price as the round lot portion of the PRL order and processed in the Odd-Lot Execution System;<sup>20</sup> (2) amend proposed NYSE Rule 13 to reflect that stop orders and stop limit orders may still be represented manually by a floor broker in the trading "Crowd;"<sup>21</sup> (3) amend the definition of immediate or cancel ("IOC") order in proposed NYSE Rule 13 to: (a) Propose an IOC order that is designed to be in compliance with Regulation NMS; (b) specify that NYSE IOC orders would be eligible to be routed away during a sweep; and (c) eliminate the previously proposed changes to the treatment of commitments to trade received through the Intermarket Trading System ("ITS Commitments");<sup>22</sup> (4) amend its proposed definition of Intermarket Sweep order in proposed NYSE Rule 13 to specify that this type of order would be permitted to sweep the Display Book system, and the portion that was not executed would be immediately cancelled; (5) amend proposed NYSE Rule 36 to state that a specialist may only use a wired or wireless device that has been registered with the Exchange to communicate with the Specialist Algorithms and provide that specialist firms must create and maintain records of all messages generated by the Specialist Algorithm; (6) amend proposed NYSE Rule 60 to: (a) Set forth the instances during which Autoquote<sup>23</sup> will update the quote even if automatic executions are not available; (b) set forth the instances during which Autoquote will update the quote when Autoquote and automatic execution are suspended and disseminate a 100 share quote in certain situations; and (c) propose to use an indicator when the NYSE quote is not available for automatic execution due to a gapped quotation or liquidity replenishment point ("LRP") to signify that the NYSE quote is not firm; (7) amend proposed NYSE Rule 70.20 to: (a) Permit a floor broker to leave the Crowd without canceling its floor broker

agency interest file<sup>24</sup> to recharge its handheld device and (b) specify the procedures for entering interest in the floor broker agency interest file before the open; (8) amend proposed NYSE Rule 72 to specify the priority and parity rules for instances when there are shares remaining after a sweep that triggers an LRP; (9) amend NYSE Rule 76 to reflect that it would not apply to elected stop or stop limit orders other than those manually represented in the Crowd by a floor broker; (10) amend proposed NYSE Rule 104 to: (a) Permit specialists to manually layer dealer interest in the specialist interest file; (b) permit specialists to enter certain quoting messages when automatic executions and Autoquote are suspended; (c) amend the definition of "meaningful amount" for purposes of determining when a specialist could provide price improvement; and (d) require specialists to hire independent auditors to review their algorithms on an annual basis; (11) amend proposed NYSE Rule 123A.30 to: (a) Provide systematic conversion of elected or converted percentage orders that are converted on a destabilizing tick and that permit the specialist to trade on parity ("CAP-DI orders") on the same side as a specialist when the specialist is bidding (offering) or trading and an automatic execution occurs against a specialist's proprietary interest and (b) clarify the execution of contra-side elected and converted CAP-DI orders; (12) amend proposed NYSE Rule 123F to codify that NYSE may execute an Auction Limit ("AL") order or market order at a price that matches a better away market; (13) amend proposed NYSE Rule 1000 to: (a) Clarify that automatic executions will resume in the same manner as Autoquote; (b) prohibit short sale orders, except those for Regulation SHO<sup>25</sup> pilot securities, from sweeping the Display Book system; (c) eliminate the provision that would have suspended the operation of Direct+ when an away market disseminates a better quote; (d) eliminate the proposal that would have permitted automatic executions to continue while the specialist reports a block trade until the quote decremented to 100 shares; (e) specify the process for determining when a security that is priced at \$300.00 or more would be eligible for automatic executions; (f) specify that automatic executions would be suspended on one side of the market when a bid (offer) is

and George Rutherford, Consultant, dated December 11, 2005 ("Rutherford Letter VII"), December 17, 2005 ("Rutherford Letter VIII"), February 1, 2006 ("Rutherford Letter IX"), and February 13, 2006 ("Rutherford Letter X").

<sup>14</sup> See Letter from Mary Yeager, Assistant Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated September 21, 2005 ("Response to Comments").

<sup>15</sup> See Form 19b-4 dated September 16, 2005 ("Amendment No. 6").

<sup>16</sup> See Form 19b-4 dated October 11, 2005 ("Amendment No. 7").

<sup>17</sup> The Display Book system ("Display Book system") is an order management and execution facility. The Display Book system receives and displays orders to the specialists, contains the Book, and provides a mechanism to execute and report transactions and publish the results to the Consolidated Tape. In addition, the Display Book system is connected to a variety of other Exchange systems for the purposes of comparison, surveillance, and reporting information to customers and other market data and national market systems, that is, the Intermarket Trading System, Consolidated Tape Association, Consolidated Quotation System, etc.

<sup>18</sup> See Form 19b-4 dated March 14, 2006 ("Amendment No. 8").

<sup>19</sup> See note 29 *infra* and accompanying text for a description of "Auto Ex Order."

<sup>20</sup> See note 34 *infra*.

<sup>21</sup> See note 46 *infra* and accompanying text for a description of "Crowd."

<sup>22</sup> Similarly, NYSE also proposes to eliminate previously proposed changes to the treatment of ITS Commitments in NYSE Rule 15A.60.

<sup>23</sup> See note 58 *infra* and accompanying text for a description of Autoquote.

<sup>24</sup> See note 43 *infra* and accompanying text for a description of the floor broker agency interest file.

<sup>25</sup> See Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

outside the momentum LRP;<sup>26</sup> (g) specify that any shares remaining after an execution in IOC orders, NYSE IOC orders, or Intermarket Sweep orders would be cancelled after sweeping the Display Book system; and (h) clarify that auto ex limit orders, except IOC orders, that are not able to be immediately executed due to a suspension of Direct+ would be placed in the Book; and (14) amend Rule 1001.

On December 14, 2005, the Commission approved on an accelerated basis a proposed rule change by the Exchange to implement and test certain proposed functions of the Hybrid Market, known as Phase 1 of the Hybrid Market, on a pilot basis ("Pilot").<sup>27</sup>

This order approves the proposed rule change, as amended by Amendment Nos. 1, 2, 3, 5, 6, 7, and 8. The Commission is also providing notice and soliciting comments on Amendment Nos. 6, 7, and 8 to the proposed rule change.

## II. Description of the Proposal

Currently, NYSE is primarily a floor-based auction market. NYSE members operate on the NYSE floor, representing their customers' orders for execution in a largely manual environment. NYSE provides limited automated access to its market through its automatic execution facility, Direct+. According to NYSE, automatic executions represent approximately 11% of its market share volume, with the bulk of executions occurring manually in its floor-based auction.<sup>28</sup> With this proposed rule change, NYSE has proposed to alter the way its market operates by allowing more orders to be executed automatically in Direct+. In essence,

NYSE has proposed to move from a floor-based auction market with limited automated order interaction to a more automated market with limited floor-based auction market availability.

To create its Hybrid Market, NYSE has proposed changes to its current Direct+ rules to make the system available to more order types and to limit the instances when automatic executions are not available. In addition, NYSE has proposed to permit its floor members to participate in its expanded automated market in an electronic fashion. Specifically, NYSE has proposed to permit specialists and floor brokers to electronically provide liquidity that would be available for automatic executions.

In addition, NYSE has proposed changes to its auction market to accommodate those investors that wish to continue to have their orders exposed for price improvement. To this end, NYSE has proposed to create a new order type—the Auction Limit order, and to amend the way market orders are handled in the auction.

### A. Proposed Automated Market

#### 1. Automated Access To Display Book System

Currently, Direct+ is only available, with respect to stocks, to designated marketable limit orders, without tick restrictions, of 1,099 shares or less ("Auto Ex Orders").<sup>29</sup> In addition, multiple Auto Ex Orders are not allowed to be entered for the account of the same person within a 30-second time period from the entry of an initial Auto Ex Order.<sup>30</sup> Auto Ex Orders trade only against interest reflected in the Exchange's published quotation—that is, the NYSE best bid or offer ("BBO"). Eligible limit orders are not required to be entered as Auto Ex Orders. Rather, the member organization entering the order (or its customer if enabled by the member organization) must make a specific designation to choose to enter an order into Direct+.

NYSE proposes to broaden access to Direct+ for stocks and ETFs.<sup>31</sup>

Specifically, NYSE has proposed to amend its Rule 13 to define an Auto Ex Order to include: (1) All marketable limit orders;<sup>32</sup> (2) designated market orders; (3) designated IOC orders;<sup>33</sup> (4) elected stop and stop limit orders that have been systematically delivered to the Display Book system; (5) buy minus, sell plus, and short sale orders systematically delivered to the Display Book system; (6) CAP-DI Orders; (7) the round lot portion of a PRL order;<sup>34</sup> (8) orders that were initially eligible for automatic execution that have been cancelled and replaced with a subsequent Auto Ex Order;<sup>35</sup> and (9) Intermarket Sweep orders.<sup>36</sup> In addition,

<sup>32</sup> Marketable limit orders, *i.e.*, limit orders to buy (sell) priced at or above (below) the best offer (bid) at the time the order is routed to the Display Book system, would no longer need to be designated as requesting an automatic execution in Direct+. All marketable limit orders would be automatically executed with or without designation. See proposed NYSE Rule 13. Non-marketable limit orders would be routed to the Display Book system, even if designated auto ex, and would be displayed as limit orders on the Book. See proposed NYSE Rule 1000(d)(v); see also Amendment No. 8. These booked orders would be available to participate in sweep transactions. When such orders become marketable, they would be included in the quote and could participate in automatic executions.

<sup>33</sup> NYSE proposes two types of IOC orders. See proposed NYSE Rule 13; see also Amendment No. 8. One would be for the purposes of Regulation NMS which would not be routed to away markets during a sweep. Instead, if an away market is disseminating a better protected bid or offer, the IOC order would be cancelled. The other type of IOC order, the NYSE IOC order, would allow NYSE to route portions to away markets to satisfy better protected bids or offers and would cancel once it was no longer able to receive an execution on NYSE. The Exchange also proposes to amend the definition of an IOC order to permit the entry of IOC orders before the opening of the Exchange for participation in the opening trade. If not executed as part of the opening trade, the order would be treated as cancelled.

<sup>34</sup> See proposed NYSE Rule 13; see also Amendment No. 8. Odd-lot orders and odd-lot portions of PRLs would not be eligible for automatic execution in Direct+. The Exchange noted that, under NYSE Rule 124, odd-lot orders are received, processed, and executed by an Exchange system designated for such purpose with the specialist as the contra-party at the price of certain round-lot transactions ("Odd-Lot Execution System"). Accordingly, the Odd-Lot Execution System provides a type of automatic execution that is governed by NYSE Rule 124, not the rules governing Direct+. The Exchange also clarified in the Third Notice that when automatic executions are suspended, odd-lot executions also would be suspended to prevent odd-lots from trading at prices unrelated to round-lot orders in the same security and to provide consistency in the availability of automatic executions.

<sup>35</sup> Currently, the Display Book system changes an order that cancels and replaces an Auto Ex Order to a non-Auto Ex Order. Under the Hybrid Market, the Display Book system would no longer make this change, so that a cancel/replace order of an Auto Ex Order would now be eligible for automatic execution.

<sup>36</sup> A few order types would be ineligible for automatic execution, including CAP, "opening only" (OPG), "limit on close" (LOC), "market on close" (MOC), and "basis" (BAS) orders.

<sup>26</sup> See note *infra* and accompanying text for a description of momentum LRPs.

<sup>27</sup> See Securities Exchange Act Release No. 52954, 70 FR 75519 (December 20, 2005). See also Third Notice, *supra* note 11, for a description of Phase 1 of the Hybrid Market implementation plan. The Commission notes that it received one comment letter opposing the implementation of the Pilot. See Letter from George Rutherford, Consultant, dated December 13, 2005. On February 21, 2006, the Exchange filed a proposed rule change pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(5) thereunder to amend the manner in which CAP-DI orders convert in certain situations ("Pilot Amendment"). See Securities Exchange Act Release No. 53359 (February 24, 2006), 71 FR 10736 (March 2, 2006). On March 13, 2006, the Exchange filed a proposed rule change pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(6) thereunder to extend the Pilot until March 24, 2006 ("Pilot Extension"). See Securities Exchange Act Release No. 53487 (March 15, 2006), 71 FR 14278 (March 21, 2006).

<sup>28</sup> See NYSE Market Statistics (visited on March 9, 2006), <http://www.nyse.com/Frameset.html?displayPage=/marketinfo/102221393893.html> (noting that Direct+ volume, for the year ended December 31, 2005, is 11.4% of NYSE volume).

<sup>29</sup> See NYSE Rules 13 and 1000. Orders in Investment Company Units (as defined in paragraph 703.16 of the Listed Company Manual), Trust Issued Receipts (as defined in NYSE Rule 1200), streetTRACKS Gold Shares (as defined in NYSE Rule 1300), or any product subject to the same rules as Investment Company Units (collectively "ETFs"), however, may be entered in a size greater than 1,099 shares. See Securities Exchange Act Release No. 52160 (July 28, 2005), 70 FR 44963 (August 4, 2005) (amending NYSE Rules 13 and 1005 to eliminate the 10,000 share restriction and the 30-second order entry restriction for Auto Ex Orders in ETFs).

<sup>30</sup> See NYSE Rule 1005.

<sup>31</sup> See proposed NYSE Rule 1002.

NYSE proposes to eliminate the size restrictions for Auto Ex Orders and eliminate the 30-second order entry restriction.

## 2. Liquidity Available for Automatic Execution

Currently, the Display Book system contains the Book, which is operated and represented by the specialist. The Book contains limit orders routed to NYSE through SuperDOT<sup>37</sup> or left with the specialist by floor brokers for representation. The Display Book system also may reflect specialist quotes at the NYSE BBO. Auto Ex Orders interact with the interest displayed on the Display Book system at the NYSE BBO.

To further automate its market, NYSE has proposed to permit its floor members—that is, specialists and floor brokers—to place liquidity in the Display Book system at various prices, in newly-created separate files that would be available for execution against incoming Auto Ex Orders. This would allow floor members and the investors they represent on the floor to more fully participate in automatic executions.

### (a) Specialist Interest File and Reserve

Specialists would have the ability to manually and systematically place in a separate file (“specialist interest file”) within the Display Book system their dealer interest at prices at or outside the Exchange BBO.<sup>38</sup> NYSE intends the specialist interest file to assist the specialist, in an automated environment, to fulfill its obligations to provide capital, bridge temporary gaps in supply and demand, and dampen volatility. In addition, the specialist interest file would allow specialists to provide increased liquidity at prices at or outside the Exchange BBO, which could potentially improve the prices at which Auto Ex Orders are executed.<sup>39</sup>

The Exchange also proposes to provide specialists with the ability to maintain undisplayed reserve interest on behalf of their dealer accounts at the Exchange BBO, provided that they display at least 2,000 shares of dealer interest at that price on the same side of the market as the reserve.<sup>40</sup> After an execution against a specialist’s displayed bid (offer), if the specialist has reserve interest remaining at that best bid (offer), the amount of displayed

interest would be automatically replenished by the specialist’s reserve interest, if any, so that at least 2,000 shares of specialist interest is displayed (or whatever specialist interest remains at the best bid (offer), if less than 2,000 shares).<sup>41</sup>

Specialist interest at the Exchange BBO would be disseminated; specialist reserve and specialist interest away from the Exchange BBO ordinarily would not be disseminated. Each specialist, however, has the option to disseminate its interest away from the Exchange BBO via OpenBook<sup>42</sup> or another Exchange data distribution channel.

### (b) Floor Broker Agency Interest File and Reserve

Floor brokers, similarly, would be permitted to represent electronically the orders they hold by including these orders in a separate file (“floor broker agency interest file”) within the Display Book system.<sup>43</sup> Floor brokers would be permitted to place liquidity electronically at or outside the Exchange BBO. In addition, floor broker agency interest files would be allowed to participate in the opening trade.<sup>44</sup> Floor brokers would not be permitted to enter in the floor broker agency interest files any interest that restricts the specialist’s ability to trade on parity with the floor broker agency interest file.<sup>45</sup>

A floor broker would be required to be in close physical proximity to the post for the security—that is, in the Crowd<sup>46</sup>—while it has orders in its floor broker agency interest file.<sup>47</sup> NYSE would

require that a floor broker’s agency interest file be cancelled when the floor broker leaves the Crowd.<sup>48</sup> If the floor broker nevertheless leaves the Crowd without canceling its agency interest files, and one or more executions occur with its agency interest, the floor broker would be held to such executions.<sup>49</sup>

Because the floor broker agency interest file is part of the Display Book system and because of the specialist’s obligation to maintain a fair and orderly market, the Exchange proposes to allow the specialist ordinarily to see the aggregate number of shares of all floor broker agency interest files at each price.<sup>50</sup> A floor broker, however, would have the option to exclude all of its floor broker agency interest file from the information available to the specialist.<sup>51</sup> A floor broker’s ability to exclude volume from the aggregate agency interest information available to the specialist would not be available during the open.<sup>52</sup> Floor broker agency interest excluded from the aggregated agency interest information available to the specialist would be able to participate in automatic executions, but would not participate in a manual execution unless the floor broker represents the interest manually.<sup>53</sup> Furthermore, floor broker agency interest that has been excluded from the aggregate information available to the specialist would not participate in the closing trade.<sup>54</sup>

The Exchange proposes to permit floor brokers to maintain undisplayed reserve interest at the Exchange BBO provided that a minimum of 1,000 shares of the floor broker’s agency interest is displayed at that price.<sup>55</sup> If an execution at the Exchange BBO occurs that does not exhaust the broker’s interest at that price, the displayed interest would be automatically replenished from the floor broker’s reserve interest, if any, so that at least 1,000 shares (or whatever amount remains, if less than 1,000 shares) is displayed.<sup>56</sup> There would be no reserve capability for floor broker agency

floor broker is not in the Crowd. See proposed NYSE Rule 70.20(j)(ii); see also Amendment No. 8.

<sup>48</sup> See proposed NYSE Rule 70.20(f). However, a floor broker could leave the Crowd to recharge its handheld device without canceling its interest. See *id.* See also Amendment No. 8.

<sup>49</sup> See proposed NYSE Rule 70.20(f).

<sup>50</sup> See proposed NYSE Rule 70.20(g). Specialists would not be able to see individual orders represented in the floor broker agency interest file.

<sup>51</sup> See *id.*

<sup>52</sup> See proposed NYSE Rule 70.20(k).

<sup>53</sup> See proposed NYSE Rule 70.20(h).

<sup>54</sup> See proposed NYSE Rule 70.20(k).

<sup>55</sup> See proposed NYSE Rule 70.20(c)(ii).

<sup>56</sup> See proposed NYSE Rule 70.20(c)(iii).

<sup>37</sup> SuperDOT is an electronic order-routing system used by NYSE member firms to send market and limit orders to NYSE. SuperDOT is also referred to as DOT.

<sup>38</sup> See proposed NYSE Rules 104(b)(i) and 104(c)(viii); see also Amendment No. 8 and Pilot.

<sup>39</sup> See Response to Comments, *supra* note 14.

<sup>40</sup> See proposed NYSE Rule 104(d)(i).

<sup>41</sup> See proposed NYSE Rule 104(d)(ii).

<sup>42</sup> OpenBook is a compilation of limit order data for all NYSE traded securities that the Exchange provides to market data vendors, broker-dealers, private network providers, and other entities through a data feed. See Securities Exchange Act Release No. 44138 (December 7, 2001), 66 FR 64895 (December 14, 2001).

<sup>43</sup> See proposed NYSE Rule 70.20(a)(i).

<sup>44</sup> See proposed NYSE Rule 70.20(j)(i). Floor broker agency interest entered before the open could participate in the opening trade on parity with the Book in accordance with Exchange policies that govern the open.

<sup>45</sup> See proposed NYSE Rule 70.20(a)(i).

<sup>46</sup> See proposed NYSE Rule 70.30. The Exchange proposes to define a Crowd as being any five contiguous panels at any one post where securities are traded. A floor broker would be considered to be in the Crowd if it is physically present at one of the five contiguous panels. However, the requirement that a floor broker be in the Crowd to have agency interest files would not apply to orders governed by section 11(a)(1)(G) of the Act (“G” orders), 15 U.S.C. 78k(a)(1)(G). See proposed NYSE Rule 70.20(a)(ii).

<sup>47</sup> A floor broker could enter interest in its agency interest file prior to the open regardless of its location on the floor, but would have to be in the Crowd at the open to participate in the opening trade. Any agency interest entered prior to the open would have to be cancelled before the open, if the

interest entered into the files during the open and close.<sup>57</sup>

The floor broker agency interest file at the Exchange BBO, except reserve, would be disseminated. Floor broker agency interest away from the BBO would not be displayed in OpenBook or other Exchange data distribution channel.

### 3. Autoquote

Autoquote is part of the Display Book system that immediately displays customer limit orders received on the Exchange.<sup>58</sup> Autoquote immediately updates the NYSE BBO when a customer limit order is received by NYSE that improves the NYSE quote.<sup>59</sup> In addition, Autoquote updates the NYSE BBO when an execution occurs to reflect a new NYSE BBO from interest held in the Display Book system. The Exchange proposes to amend its Rule 60 to modify the circumstances under which Autoquote would be suspended.

Specifically, Autoquote would be suspended in three circumstances: (1) When the specialist manually reports a block size transaction that involves orders in the Display Book system; (2) when the specialist gaps the quote;<sup>60</sup> or (3) when a LRP is reached.<sup>61</sup> When Autoquote is suspended due to a manual report of a block trade that involves orders in the Display Book system,<sup>62</sup> Autoquote would resume when the manual reporting is concluded.<sup>63</sup> When Autoquote is suspended following a gap quote, Autoquote would resume upon the report of a manual transaction or the publication of a non-gapped quotation.<sup>64</sup>

When Autoquote is suspended by an LRP that is reached by an Auto Ex Order that sweeps to the LRP price,<sup>65</sup> and if the Auto Ex Order is filled or if its unfilled balance is not capable of trading at a price beyond the sweep LRP price, then Autoquote would resume in no more than five seconds after the LRP is reached.<sup>66</sup> If the Auto Ex Order is capable of trading at a price beyond the LRP price, and would not create a

locked or crossed market if quoted, then Autoquote would resume upon the report of a manual transaction or the publication of a new quote by the specialist, but in any event in no more than ten seconds.<sup>67</sup> Finally, if the Auto Ex Order is capable of trading at a price beyond the LRP price but would create a locked or crossed market if quoted, then Autoquote would resume upon a manual transaction or the publication of a new quote by the specialist.<sup>68</sup>

When Autoquote is suspended by a momentum LRP ("MLRP"),<sup>69</sup> Autoquote would resume in no more than ten seconds unless the Auto Ex Order would create a locked or crossed market.<sup>70</sup> If a locked or crossed market exists, Autoquote would resume once a manual transaction is reported.<sup>71</sup>

Autoquote would update the quote in the following situations even though automatic executions are not available. First, when the Exchange best bid (offer) is outside a MLRP, and such MLRP has not yet been reached, the Exchange would permit Autoquote to continue to operate, while automatic executions are not available.<sup>72</sup> Second, NYSE would keep Autoquote active when an order or a cancellation of an order arrives that would not result in a locked or crossed market in a security priced at \$300 or more that has been determined to be ineligible for automatic execution ("high-priced security")<sup>73</sup> or a manual execution takes place in such security.<sup>74</sup> Third, if there is a cancellation of the Exchange best bid (offer) in a high-priced security when the market in such security is internally locked or crossed, and autoquoting of the next best bid (offer) would create a locked or crossed market on the Exchange, NYSE would automatically generate a quote of 100 shares at the bid (offer) price that existed at the time of the cancellation.<sup>75</sup>

Finally, in the following situations, the Exchange would update its quote even though Autoquote is suspended due to an LRP or a gapped quotation, and automatic executions are not available: (1) If part of the existing

Exchange best bid (offer) cancels, the Exchange would use Autoquote to update its quote to reflect the remaining volume;<sup>76</sup> (2) if the entire existing Exchange best bid (offer) cancels, the Exchange would automatically generate a quote of 100 shares at the bid (offer) price that existed at the time of the cancellation;<sup>77</sup> or (3) if there is a cancellation of the Exchange best bid (offer) when the market is internally locked or crossed, and autoquoting of the next best bid (offer) would create a locked or crossed market on the Exchange, NYSE would automatically generate a quote of 100 shares at the bid (offer) price that existed at the time of the cancellation.<sup>78</sup>

### 4. Automatic Executions

Currently, an Auto Ex Order equal to or greater than the size of the Exchange's BBO trades with the entire published bid or offer,<sup>79</sup> and a new bid or offer is then published. If any shares of an Auto Ex Order remain available for execution after it trades with the published quote, the remaining shares are routed to the floor and represented in the auction market.<sup>80</sup> Auto Ex Orders that cannot be immediately executed are placed in the Book and represented as limit orders in the auction market.<sup>81</sup> When the national best bid or offer ("NBBO") is disseminated by another market and an Auto Ex Order is delivered to the specialist, it must either match the better price displayed by the other market or send an ITS Commitment to the other market.<sup>82</sup>

As proposed, Auto Ex Orders would execute against interest at the Exchange BBO including displayed interest and reserve.<sup>83</sup> Once an Auto Ex Order trades with interest at the BBO, NYSE proposes to permit Auto Ex Orders, except ITS Commitments, to automatically "sweep" the Display Book system by trading with liquidity that is outside the BBO. Specifically, after exhausting the volume at the BBO, the shares of the Auto Ex Order that remain (the "residual") would trade with existing orders in the Book, floor broker agency interest files, and the specialist interest file, until the Auto Ex Order is executed, its limit price, if any, is

<sup>57</sup> See proposed NYSE Rule 70.20(k).

<sup>58</sup> This system was developed to facilitate specialists' compliance with the Commission's Limit Order Display Rule. See 17 CFR 242.604.

<sup>59</sup> NYSE Rule 60(e).

<sup>60</sup> See note 139 *infra*, for a description of gapped quotations.

<sup>61</sup> See proposed NYSE Rule 60(e)(i). See Section II(A)(5)(a) *infra*, and proposed NYSE Rule 1000(a)(iv) for a description of LRPs.

<sup>62</sup> See proposed NYSE Rule 1000(a)(v). See Section II(A)(5) *infra*.

<sup>63</sup> See proposed NYSE Rule 60(e)(ii)(B).

<sup>64</sup> See proposed NYSE Rule 60(e)(ii)(A).

<sup>65</sup> See Section II(A)(5)(a)(1) *infra*.

<sup>66</sup> See proposed NYSE Rule 60(e)(ii)(C).

<sup>67</sup> See *id.*

<sup>68</sup> See *id.* In Amendment No. 8, the Exchange represented that it would implement an alert for specialists to facilitate their compliance with the Commission's Limit Order Display Rule, 17 CFR 242.604.

<sup>69</sup> See Section II(A)(5)(a)(2) *infra*.

<sup>70</sup> See proposed NYSE Rule 60(e)(iii).

<sup>71</sup> See *id.* See also note 68 *supra*.

<sup>72</sup> See proposed NYSE rule 60(e)(iv)(a); see also Amendment No. 8.

<sup>73</sup> See note 142 *infra* and accompanying text on the definition of high-priced security.

<sup>74</sup> See proposed NYSE rule 60(e)(iv)(b)(i); see also Amendment No. 8.

<sup>75</sup> See proposed NYSE rule 60(e)(iv)(b)(ii); see also Amendment No. 8.

<sup>76</sup> See proposed NYSE rule 60(e)(iv)(c)(i); see also Amendment No. 8.

<sup>77</sup> See proposed NYSE rule 60(e)(iv)(c)(ii); see also Amendment No. 8.

<sup>78</sup> See proposed NYSE rule 60(e)(iv)(c)(iii); see also Amendment No. 8.

<sup>79</sup> See NYSE Rule 1000(a).

<sup>80</sup> See NYSE Rule 1001(b).

<sup>81</sup> See NYSE Rule 1000.

<sup>82</sup> See NYSE Rule 15A.

<sup>83</sup> See proposed NYSE Rule 1000(d).

reached, or a LRP is reached, whichever occurs first.<sup>84</sup>

During a sweep, the residual would trade with the orders in the Display Book system, floor broker agency interest, and any specialist interest capable of execution, at a single price (the “clean-up price”), such that any price improvement is given to the orders and interest in the Display Book system rather than the Auto Ex Order.<sup>85</sup> Accordingly, orders in the Book, floor broker agency interest, and any specialist interest capable of trading with the residual would receive the clean-up price.<sup>86</sup> Any specialist interest that remains at the clean-up price after the residual has traded would be automatically cancelled by the Exchange.<sup>87</sup>

Any residual remaining after the sweep would become a bid (offer) at the order’s limit price, if any, or the LRP price, whichever is lower (higher).<sup>88</sup> If the residual can execute at the price at which it is bidding (offering), it would have priority for one trade over other interest at that price.<sup>89</sup> If the residual executes at a different price—within the parameters of its limit, if any—it would trade on parity.<sup>90</sup> If an Auto Ex Order is designated IOC, any unfilled balance remaining after the sweep would be automatically cancelled.<sup>91</sup>

Current NYSE Rule 1001(a)(iv) provides that the specialist shall be the contra party for any automatic execution of an Auto Ex Order where the interest reflected in the published bid or offer is no longer available. This obligation exists regardless of the tick associated with the automatic execution. NYSE Rule 104, however, restricts the specialist’s ability to purchase stock on direct plus ticks or sell stock on direct minus ticks. As part of its initial proposal establishing Direct+, the Exchange sought and received Commission approval of an interpretation of NYSE Rule 104 that provides that any instance in which the specialist is effecting such a direct tick transaction only because it has been required to assume the contra-side of an automatic execution shall be deemed to be a “neutral” transaction for purposes of NYSE Rule 104, and shall not be deemed a violation of the Exchange rule.<sup>92</sup> The Exchange requests that the

Commission extend this interpretation to its Hybrid Market proposal.

Automatic executions of Auto Ex Orders may elect stop orders, stop limit orders, and percentage orders electable at the price of such executions.<sup>93</sup> Currently, any stop orders so elected are executed pursuant to Exchange auction market procedures and are not guaranteed an execution at the same price as subsequent automatic executions of Auto Ex Orders.<sup>94</sup> The Exchange previously sought and the Commission approved an interpretation<sup>95</sup> that, for the purposes of NYSE Rule 123A, the specialist is not required to fill any stop orders elected by an execution of an Auto Ex Order at the price of the electing sale in any instance where the specialist was required by NYSE Rule 1001(a)(iv) to take the contra-side of a Direct+ execution. NYSE proposes to retain this interpretation.

#### (a) Priority, Parity, and Precedence

NYSE executions are governed by its rules of priority, parity, and precedence.<sup>96</sup> These rules dictate which order or quote is able to execute against an incoming order and the allotment of shares, if more than one order or quote is at the BBO. Generally, the first bid (offer) at the BBO has priority to execute against the next incoming order.<sup>97</sup> Once a trade occurs with the bid (offer) that has priority, other bids (offers) at that price (including any remaining interest from the bid (offer) that had priority) generally trade on parity, meaning they split evenly the remainder of the incoming order, up to the size of their own order.<sup>98</sup>

A specialist must always yield priority to the orders it represents on the Book,<sup>99</sup> and today is limited somewhat in its ability to trade with orders represented by floor brokers. Specifically, when the specialist is decreasing or liquidating its dealer position, the specialist is entitled to trade on parity with orders represented by floor brokers, unless the floor broker (or its customer) requests that the

specialist refrain from trading along with the order the floor broker represents.<sup>100</sup> When a specialist is establishing or increasing its dealer position, NYSE Rule 108 states that the specialist is not “entitled” to parity with orders represented on the floor. According to NYSE, it has interpreted this rule to permit specialist trading on parity when establishing or increasing a position if the specialist is granted permission from the floor broker (or its customer) to do so.<sup>101</sup>

In its Hybrid Market, the Exchange proposes to amend its rules that govern priority, parity, and precedence with respect to interest placed in the Display Book system. Generally, an incoming Auto Ex Order would trade first with the displayed bid (offer) that established the BBO.<sup>102</sup> If the Auto Ex Order is of greater size than the bid (offer) that has priority, the remaining balance of the Auto Ex Order would trade with other displayed interest at the BBO.<sup>103</sup> The additional displayed interest would trade on parity.<sup>104</sup> Thereafter, if the Auto Ex Order has size remaining to be executed, it would then execute against undisplayed specialist or floor broker reserve at the BBO, which would trade on parity.<sup>105</sup>

The Exchange proposes that all floor broker agency interest files at the same price be on parity with each other, except a floor broker agency interest file that establishes the BBO would be entitled to priority in accordance with NYSE Rule 72.<sup>106</sup> Finally, with respect to transactions against the published bid or offer, no published bid or offer may claim precedence based on size with respect to executions against Auto Ex Orders.<sup>107</sup>

<sup>100</sup> See NYSE Rule 104.10(6)(i)(C).

<sup>101</sup> See NYSE Information Memo 05–81 (October 26, 2005) (interpreting NYSE Rule 108(a) as permitting a specialist to be on parity with orders in the Crowd when the specialist is establishing or increasing its position, provided that the brokers representing orders in the Crowd permit the specialist to trade along with them by not objecting to such participation). See Securities Exchange Act Release No. 53208 (February 2, 2006), 71 FR 6804 (February 9, 2006).

<sup>102</sup> See proposed NYSE Rule 1000(d)(i). If the specialist establishes the BBO, however, it would have to yield to all interest in the Book.

<sup>103</sup> See proposed NYSE Rule 1000(d)(ii). As noted above, floor brokers would not be permitted to enter interest into its floor broker agency interest files that restricts the specialist’s ability to trade on parity. In addition, specialists would not be permitted to trade on parity until orders in the Book at the same price are executed in full.

<sup>104</sup> See proposed NYSE Rule 1001(a)(i).

<sup>105</sup> See proposed NYSE Rules 1000(d)(ii)(A), 70.20(c)(iv), and 104(d)(iii).

<sup>106</sup> See proposed NYSE Rule 70.20(b).

<sup>107</sup> See proposed NYSE Rule 1001(b). This reflects the current NYSE Rule 1001(c), which is proposed

Continued

<sup>84</sup> See proposed NYSE Rule 1000(d)(ii)(A)–(D).

<sup>85</sup> See proposed NYSE Rule 1000(d)(iii)(A).

<sup>86</sup> See proposed NYSE Rule 1000(d)(iii)(B).

<sup>87</sup> See proposed NYSE Rule 1000(d)(iii)(C)(ii).

<sup>88</sup> See proposed NYSE Rule 1000(d)(iv).

<sup>89</sup> See proposed NYSE Rule 72(j); see also Amendment No. 8.

<sup>90</sup> See *id.*

<sup>91</sup> See proposed NYSE Rule 1000(d)(iv).

<sup>92</sup> See note 203 *infra*.

<sup>93</sup> See NYSE Rule 1004.

<sup>94</sup> See *id.*

<sup>95</sup> See note 203 *infra*.

<sup>96</sup> See NYSE Rules 72, 104, and 108.

<sup>97</sup> See NYSE Rule 72 I(a). A bid (offer) that establishes the Exchange BBO is entitled to priority at that price for one trade, except a specialist bid or offer entitled to priority must yield to limit orders on the Book at the same price.

<sup>98</sup> See NYSE Rule 72 III. When bids (offers) are on parity, Exchange rules dictate that in certain circumstances, a particular participant is guaranteed a portion of an order based on the size of its bid (offer), *i.e.*, precedence based on size. See NYSE Rule 72 I(c).

<sup>99</sup> See NYSE Rule 92.

In Amendment No. 6, the Exchange proposes to amend NYSE Rule 70.20(d)(i) to provide that, during a sweep, the amount of floor broker agency interest that would have been displayed had the clean-up price become the Exchange BBO would trade on parity with displayed interest (*i.e.*, orders on the Book) at that price.<sup>108</sup> The amount of any floor broker agency interest that would have been placed in the broker's reserve, however, would yield to displayed interest.<sup>109</sup>

The Exchange proposes that interest reflected in the specialist interest file would be entitled to trade on parity with interest in the floor broker agency interest file, regardless of whether the specialist is increasing or decreasing its position, but, in all cases, specialist interest would have to yield to orders in the Book. Specifically, during a sweep, if no orders remain on the Book capable of trading at the clean-up price, specialist interest could trade and would be on parity with floor broker interest at that price.<sup>110</sup> During a sweep, neither the specialist interest file nor the floor broker agency interest file could claim precedence based on size.<sup>111</sup>

The Exchange also proposes to modify NYSE Rule 72 III to add that a cancellation of an entire bid or offer entitled to priority under the rule would clear the floor, after which all bids and offers would be deemed to be re-entered and on parity.<sup>112</sup> The Exchange believes this amendment is warranted because a cancellation of a bid or offer that was entitled to priority has the same effect as a trade.

To summarize, the following describes the sequence of execution against an incoming Auto Ex Order in the Hybrid Market:

#### *Interest at Exchange BBO*

An incoming Auto Ex Order would first trade with displayed interest at the

Exchange BBO. Within this category, the order of execution would be:

- First, interest that clearly establishes the BBO would be entitled to priority at that price for one trade, except that specialist interest that clearly established the BBO would yield to all later-arriving limit orders at the BBO on the Book. If there are no limit orders on the Book at the BBO, specialist interest that clearly established the BBO would be entitled to priority over the floor broker agency interest file for one trade.

- Second, all other displayed interest at the BBO would trade on parity, except that specialist interest displayed at the BBO could not trade until all limit orders on the Book at the BBO are filled. If there are no limit orders on the Book at the BBO, specialist interest displayed at that price would trade on parity with the floor broker agency interest files displayed at the BBO. A specialist's ability to trade on parity with the floor broker agency interest files would not be restricted by the specialist's proprietary position (*i.e.*, the specialist would trade on parity whether establishing/increasing or liquidating/decreasing its position).<sup>113</sup>

- Third, reserve interest (*i.e.*, non-displayed interest) of the specialist or floor broker at the BBO would trade on parity. Additional specialist interest (*i.e.*, other non-displayed interest generated by the Specialist Algorithm) at the BBO would trade only if no other interest exists at the BBO.<sup>114</sup>

#### *Interest Outside Exchange BBO That Participates in a Sweep*

- Orders on the Book outside the Exchange BBO would trade at the clean-up price on parity with the amount of floor broker agency interest that would have been displayed had the clean-up price become the Exchange BBO. The amount of any floor broker agency interest that would have been placed in the broker's reserve would yield to displayed interest.

- Specialist interest would participate in the sweep provided there are no limit orders on the Book remaining at the clean-up price. Specialist interest participating in the sweep would trade on parity with any remaining floor broker agency interest at the clean-up price.

#### *(b) Automated Routing Away*

In the case of all orders submitted to the Exchange electronically, except for

certain IOC orders, ITS Commitments, and Intermarket Sweep orders, where a better bid or offer is published by another ITS participating market center in which an automatic execution is available, or a published bid or offer is otherwise protected from a trade-through by Commission rule or the Intermarket Trading System plan, and the specialist has not systematically matched the price associated with that better bid or offer, the Exchange would automatically route to such other market center a commitment to trade that satisfies that published bid or offer, unless the member entering the order indicates that it has contemporaneously satisfied the better published bid or offer.<sup>115</sup> If the commitment to trade is not filled or not filled in its entirety, the balance would be returned to the Exchange and handled consistent with the order's instructions, which includes automatic execution, if available.<sup>116</sup> The order entry time associated with this returned portion of the order would be the time of its return, not the time the order was first entered on the Exchange.<sup>117</sup> With respect to the operation of sweeps, automated bids (offers) published by away markets that are better than the clean-up price would be satisfied in their entirety unless the order is an IOC order<sup>118</sup> or an Intermarket Sweep order.<sup>119</sup>

#### *(c) Tick-Restricted Orders, Stop Orders, and Other Orders Eligible for Automatic Execution*

Tick-restricted orders in the Display Book system would be filled electronically and participate in automatic executions and sweeps as their ticks and limits, if any, allow.<sup>120</sup> Specifically, buy sweeps would cause short sales and sell plus orders to be executed above the offer, while sell sweeps would cause buy minus orders to be executed below the bid. Sell short orders, other than those involving Regulation SHO pilot securities, would not sweep the Display Book system after automatically executing against the bid,

in this filing to be renumbered as NYSE Rule 1001(b).

<sup>108</sup> As noted earlier, floor broker agency interest would not be disseminated unless at the Exchange's BBO.

<sup>109</sup> See proposed NYSE Rule 70.20(d)(ii). Floor brokers would have to indicate when entering interest in the floor broker agency interest file the amount that would be displayed and the amount that would be placed in reserve if the price becomes the BBO.

<sup>110</sup> See proposed NYSE Rule 1000(d)(iii)(C)(i).

<sup>111</sup> See proposed NYSE Rule 72 I(c)-(e).

<sup>112</sup> Currently, a transaction "clears the floor," after which all bids and offers are deemed resubmitted simultaneously and are on parity, except that specialists must yield to limit orders on the Book. Cancellation of part of an order retains priority for the uncanceled portion of such order. However, canceling an order and replacing it with a larger order would result in a loss of priority for the original order.

<sup>113</sup> However, NYSE Rule 104 would continue to restrict a specialist's ability to trade on parity.

<sup>114</sup> See *infra* Section II(B)(1) for a description of this "additional specialist interest."

<sup>115</sup> See proposed NYSE Rule 15A.50

<sup>116</sup> See *id.*

<sup>117</sup> See *id.*

<sup>118</sup> In such case, the IOC order would be cancelled by NYSE to prevent trading through the away market.

<sup>119</sup> See proposed NYSE Rule 1000(d)(III)(D) and Rule 600(b)(30) of Regulation NMS, 17 CFR 242.600(b)(30).

<sup>120</sup> Specifically, the Exchange proposes in NYSE Rule 13 that sell "plus" limit orders, buy "minus" limit orders, sell "plus" market orders, and by "minus" market orders designated for automatic execution that are systematically delivered to the Display Book system be eligible to be automatically executed in accordance with NYSE Rules 1000-1004.

as the sweep transaction would occur on a minus tick.<sup>121</sup>

Under the proposal, stop orders (including stop limit orders) on the Display Book system would be electronically elected and may participate in automatic executions.<sup>122</sup> Elected stop orders on the same side of the market as the Auto Ex Order could trade at the electing bid (offer) price after the Auto Ex Order is filled to the extent that there is volume available.<sup>123</sup> In addition, an execution at the clean-up price could also elect stop orders. Elected stop orders on the same side of the market as a sweeping Auto Ex Order could trade at the clean-up price after the Auto Ex Order is filled to the extent that there is volume available.<sup>124</sup>

Furthermore, under proposed amendments to NYSE Rule 123A, the elected or converted portion of a CAP-DI order could be automatically executed and participate in a sweep. An elected or converted CAP-DI order on the same side of the market as an automatically executed electing order could participate in a transaction at the bid (offer) price if there is volume associated with the bid (offer) remaining after the electing order is filled in its entirety.<sup>125</sup> An elected or converted CAP-DI order on the same side of the market as an automatically executed electing order that sweeps the Display Book system could also participate in a transaction at the clean-up price if there is volume remaining on the Display Book system or from contra-side elected CAP-DI orders at that price.<sup>126</sup> Furthermore, an elected or converted CAP-DI order on the contra-side of the market of an automatically executed electing order could execute against the Auto Ex Order at the electing price if there is volume remaining after the Auto Ex Order executes against interest in the Display Book system at the bid (offer) price.<sup>127</sup> An elected or converted CAP-DI order on the contra-side of the market of an automatically executed electing order that sweeps the Display Book

system could execute against the Auto Ex Order at the clean-up price if there is volume remaining from the Auto Ex Order, from contra-side elected CAP-DI orders, or other interest at that price.<sup>128</sup> Finally, when a specialist is bidding (offering) or trading and an automatic execution occurs against such specialist proprietary interest, marketable CAP-DI orders on the same side as the specialist's interest would be automatically converted to participate in such execution.<sup>129</sup> If the execution elects a contra-side stop or stop limit order and the specialist is required to execute the elected stop or stop limit order, then CAP-DI orders on the same side of the market as the specialist would be automatically converted to participate in the execution of the stop or stop limit orders.<sup>130</sup>

Stop orders and CAP-DI orders could be elected at the same time by automatic executions and sweeps. If there is insufficient volume to fill the elected orders, stop orders could be executed first as they become market or marketable limit orders upon their election, whereas the elected portion of CAP-DI orders would revert to CAP-DI status if it is unable to trade. Elected CAP-DI orders are on parity with each other, which could affect the sequence in which elected stop and CAP-DI orders would trade.<sup>131</sup>

##### 5. Availability of Direct+

Current Exchange rules provide that automatic executions are available from the time the Exchange disseminates a published bid or offer until 3:59 p.m. for stocks and Trust Issued Receipts, or 4:14 p.m. for Investment Company Units, or within one minute of any other closing time of the Exchange's floor market.<sup>132</sup> Auto Ex Orders entered prior to the dissemination of a bid or offer or after 3:59 p.m./4:14 p.m. or within one minute of any other closing time, are handled in the auction market. The Exchange proposes to extend the availability of automatic executions through the close of regular trading for a particular product (e.g., 4 p.m./4:15 p.m.).<sup>133</sup>

Currently, Direct+ is not available during the trading day at the following times: (1) When the NYSE published quotation is in the non-firm quote mode; (2) when the execution price would be more than five cents away from the last

reported transaction price in the subject security on the Exchange; (3) when a better price exists in another ITS participating market center; (4) when NYSE's published bid or offer is 100 shares (on the side the order would be executed against); (5) when a block size transaction outside NYSE's published bid or offer pursuant to NYSE Rule 127 is in the process of being completed, in which case the specialist should publish a bid and/or offer that is more than five cents away from the last reported transaction price in the subject security on the Exchange;<sup>134</sup> or (6) when trading in the subject security has been halted.<sup>135</sup>

NYSE proposes to limit the instances when Direct+ is unavailable.<sup>136</sup> Specifically, pursuant to proposed NYSE Rule 1000(a),<sup>137</sup> automatic executions in Direct+ would not occur when: (1) The NYSE published quotation is in non-firm quote mode; (2) trading in a security has been halted;<sup>138</sup> (3) the quote is gapped in accordance with Exchange procedures;<sup>139</sup> (4) trading on the Exchange reaches a LRP; (5) a block size transaction, as defined in NYSE Rule 127.10,<sup>140</sup> that involves

<sup>134</sup> On January 17, 2006, the Exchange filed a proposed rule change seeking to amend the procedure for suspending automatic execution in connection with a block size transaction. See Form 19b-4 dated January 17, 2006 (SR-NYSE-2006-01). The Exchange proposes to require specialists to publish a 100 × 100 share market quote that reflects the last reported transaction in connection with a block size transaction.

<sup>135</sup> See NYSE Rule 100(a)(i)-(vi).

<sup>136</sup> In Amendment No. 8, NYSE proposes to remove its previously proposed rule that would have made Direct+ unavailable when a better price was published by an away market. As noted above, NYSE proposes to automatically route orders, except Intermarket Sweep orders and certain IOC orders, to ITS participant markets that make automatic execution immediately available and are protected from trade throughs, unless the specialist matches the better price.

<sup>137</sup> See proposed NYSE Rule 1000(a)(i)-(vi).

<sup>138</sup> No executions, either automatic or manual, would be possible on the Exchange when trading has been halted.

<sup>139</sup> A specialist could cause a non-auto-executable quote by gapping the quotation due to an order imbalance in accordance with the policies and procedures of the Exchange. Gap quotes are used to signal an imbalance so as to attract contra-side liquidity in an attempt to mitigate volatility. The size of an imbalance suitable for gapped quoting is at least 10,000 shares or a quantity of stock having a value of \$200,000 or more, although depending on the trading characteristics of the security, the appropriate conditions for gapped quoting could be higher. See NYSE Information Memo 04-27 (June 9, 2004).

When the quotation is gapped, automatic executions and Autoquote would be suspended, and the NYSE quote would be identified as non-firm. Incoming orders and cancellations would update the Book electronically. Once a trade occurs or a non-gapped quote is published, Autoquote and automatic execution would resume.

<sup>140</sup> NYSE Rule 127.10 defines a "block" size as at least 10,000 shares or a quantity of stock having a

Continued

<sup>121</sup> See proposed NYSE Rule 1000(d)(iii)(E); see also Amendment No. 8.

<sup>122</sup> See proposed NYSE Rule 13.

<sup>123</sup> Elected stop orders on the contra side of the market of the Auto Ex Order could trade with the Auto Ex Order at the electing bid (offer) price after interest in the Display Book system at such price has been filled to the extent that there is volume available from the Auto Ex Order.

<sup>124</sup> Elected stop orders on the contra side of the market of the Auto Ex Order could trade with the Auto Ex Order at the clean-up price after interest in the Display Book system at such price has been filled to the extent that there is volume available from the Auto Ex Order.

<sup>125</sup> See proposed NYSE Rule 123A.30(a)(i).

<sup>126</sup> See *id.*

<sup>127</sup> See proposed NYSE Rule 123A.30(a)(ii); see also Amendment No. 8.

<sup>128</sup> See proposed NYSE Rule 123A.30(a)(ii); see also Amendment No. 8.

<sup>129</sup> See proposed NYSE Rule 123A.30(a)(iii); see also Pilot Amendment.

<sup>130</sup> See *id.*

<sup>131</sup> See NYSE Rule 123A.30.

<sup>132</sup> See NYSE Rule 1002.

<sup>133</sup> See proposed NYSE Rule 1002.

orders in the Display Book system is being manually reported;<sup>141</sup> or (6) an Auto Ex Order is entered for a security whose closing price (or the closing bid price if there were no transactions on the previous trading day) on the Exchange is \$300 or more.<sup>142</sup> Direct+ would be unavailable on both sides of the market in these situations.<sup>143</sup> NYSE proposes to disseminate an indicator to alert investors when automatic executions are not available against its quote. In addition, when automatic executions are not available due to a LRP or gapped quotation, NYSE would disseminate an indicator to signify that the NYSE quotation is not firm.<sup>144</sup> In any instance where the automatic execution feature is not available, Auto Ex Orders would be directed to the Exchange's auction market for representation.<sup>145</sup>

#### (a) Liquidity Replenishment Points

The Exchange proposes LRPs as pre-determined price points that would halt automatic executions for varying periods of time depending on the price and remaining size, if any, of an Auto Ex Order. LRPs may be triggered by a sweep or electronic trading that results in rapid price movement over a short period. A LRP converts the electronic market to an auction market on a temporary basis, with the intent of moderating volatility in the security by affording an opportunity for new orders, the Crowd, and the specialist to add liquidity. The Exchange proposes two LRPs—a price-based or sweep LRP and a momentum LRP.

#### (1) Sweep LRPs

The sweep LRP price would be set at the nearest five-cent increment outside the Exchange BBO, rounded away to the next nearest nickel.<sup>146</sup> When a sweep

market value of \$200,000 or more, whichever is less. See Amendment No. 8.

<sup>141</sup> The Exchange originally proposed to permit automatic executions to continue while a block size transaction was manually reported until the bid (offer) decremented to 100 shares. In Amendment No. 8, NYSE proposes to suspend both Autoquote and automatic executions as soon as the report template is opened by the specialist to report a block size transaction that involves orders on the Display Book system. See proposed NYSE Rule 60(e)(ii)(B) and NYSE Rule 1000(a)(v).

<sup>142</sup> See proposed NYSE Rule 1000(a)(vi); see also Amendment No. 8. In addition, in Amendment No. 8, NYSE proposes to suspend automatic executions for such securities on both sides of the market.

<sup>143</sup> Automatic executions would be suspended on only one side of the market when an execution at the NYSE quote would trigger the MLRP. See proposed NYSE Rule 1000(c). See also proposed NYSE Rule 60(e)(iv)(a).

<sup>144</sup> See proposed NYSE Rule 60(c)(2)(b); see also Amendment No. 8.

<sup>145</sup> See NYSE Rule 1000(d)(v).

<sup>146</sup> See proposed NYSE Rule 1000(a)(iv)(A).

LRP is reached, the sweeping order would trade at that price to the extent of the volume available at that price. If there is a residual remaining after a sweep that has triggered an LRP, it would be bid (offered) at the LRP price, unless the order is NYSE IOC, IOC or Intermarket Sweep, in which case it would be cancelled.<sup>147</sup>

Automatic executions and Autoquote would then be suspended, but incoming orders and cancellations would continue to be reflected automatically in the Display Book system, although new incoming orders would not be displayed.<sup>148</sup> However, if a displayed bid (offer) cancels, a new bid (offer) would be autoquoted.<sup>149</sup>

Under the proposal, automatic executions and Autoquote would resume in no more than five seconds when the sweeping order is filled in its entirety (*i.e.*, no residual exists), when the residual is cancelled (*i.e.*, the sweeping order is IOC), or when the residual is not capable of trading at a price above (in the case of a buy order) or below (in the case of a sell order) the sweep LRP (that is, when the residual has a limit price equal to the LRP).<sup>150</sup> Automatic executions and Autoquote would resume in no more than 10 seconds when the residual is able to trade at a price above (below) the sweep LRP, but that price would not create a locked or crossed market.<sup>151</sup> Automatic executions and Autoquote would resume earlier if the specialist has manually traded or quoted the market before 10 seconds have elapsed. NYSE expects the specialist to quote or trade before 10 seconds have elapsed, unless an imbalance exists, a trade is being put together in the Crowd, or market conditions otherwise prevent such actions from occurring.

Finally, where a residual is able to trade at a price above (below) the sweep LRP, and that price would create a locked or crossed market, or when a locked or crossed market results from the entry of orders or cancellations

<sup>147</sup> See proposed NYSE Rule 1000(d)(iv). If an Auto Ex Order sweeps to its limit price and has residual remaining at the price, the residual would be bid (offered) at its limit price.

<sup>148</sup> See Second Notice, *supra* note . According to the Exchange, the Display Book system has the ability to accept incoming orders and cancellations when automatic executions and Autoquote are suspended; however, only the specialist would be able to view this information. These incoming orders and cancellations are held in the Display Book system in the sequence that they are received, until Autoquote and automatic executions are available.

<sup>149</sup> See proposed NYSE Rule 60(e)(iv)(c); see also Amendment No. 8.

<sup>150</sup> See proposed NYSE Rules 60(e)(ii)(C) and 1000(b); see also Amendment No. 8.

<sup>151</sup> See *id.*

during the 5- and 10-second periods described above, automatic executions and Autoquote would resume with a manual trade or the publication of a new quote by the specialist.<sup>152</sup> In this circumstance, there is no maximum time period after which automatic executions and Autoquote would automatically resume.<sup>153</sup> If the locking or crossing residual order cancels, automatic executions and Autoquote would resume within the relevant 5- or 10-second timeframe described above, unless a manual trade or quote occurs before then.<sup>154</sup> If the displayed bid (offer) on the contra-side of the locking or crossing residual order cancels, a new bid (offer) would be autoquoted.

#### (2) MLRPs

The momentum LRP would be triggered by a specified price movement over a specified period during a trading session. The Exchange is proposing a LRP based on price movement over a period of time because it is concerned that excessive volatility could arise in situations other than electronic sweeps. MLRPs are designed to limit the amount of price change that can occur within a 30-second time period to the greater of 25 cents or 1% of the security price (rounded to the nearest cent).

The MLRP range at any time may be calculated as follows. First, the low MLRP range is calculated by taking the high transaction price of the security within the prior 30 seconds and subtracting the greater of (a) 25 cents or (b) 1% of the security's price (rounded to the nearest cent).<sup>155</sup> Next, the high MLRP range is calculated by taking the low transaction price of the security within the prior 30 seconds and adding the greater of (a) 25 cents or (b) 1% of the security's price (rounded to the nearest cent).<sup>156</sup> For example, assume that during the prior 30 seconds, the high transaction price is \$20.15, the low transaction price is \$19.92, and the last sale price was \$20.15. The low MLRP range would be \$19.90, calculated by subtracting \$0.25 (\$0.25 is greater than 1% of the security's price) from the high transaction price of \$20.15. The high MLRP range would be \$20.17, calculated by adding \$0.25 to the low transaction price of \$19.92. The MLRP

<sup>152</sup> See proposed NYSE Rules 60(e)(ii)(C) and 1000(b).

<sup>153</sup> Specialists would still be required to immediately display customer limit orders. See Rule 604 of Regulation NMS, 17 CFR 242.604. See also proposed NYSE Rule 60(e)(ii)(C) and 60(e)(iii).

<sup>154</sup> See Second Notice, *supra* note 8.

<sup>155</sup> See proposed NYSE rule 1000(a)(iv)(B)(ii).

<sup>156</sup> See *id.*

range could change based on an event (e.g., a new trade) or the passage of time.

If there was no transaction on the Exchange within 30 seconds, the MLRP range would be based off the last transaction on the Exchange.<sup>157</sup> For example, if the last sale price was \$20.15 and no transactions have occurred within the prior 30 seconds, the low MLRP range would be \$19.90 and the high MLRP range would be \$20.40. Automatic executions could occur at prices at or within the MLRP range. Automatic executions that would occur at prices outside the MLRP range would cause the suspension of automatic executions and Autoquote. An Auto Ex Order that reaches the MLRP price would trade at that price to the extent possible, and thereafter automatic executions and Autoquote would be suspended.<sup>158</sup> The Display Book system would be automatically updated by incoming orders and cancellations, although new incoming orders would not be displayed.<sup>159</sup>

Once automatic executions and Autoquote have been suspended due to a MLRP, they generally would resume in no more than 10 seconds.<sup>160</sup> The Exchange expects, similar to a sweep LRP, that the specialist will trade or requote the stock in less than 10 seconds unless conditions in the stock prevent this. Where incoming orders and cancellations cause a locked or crossed market, Autoquote and automatic executions would resume upon a manual transaction.<sup>161</sup>

In addition, if the NYSE published bid or offer is at a price beyond the MLRP range, automatic executions on that side of the market would be suspended because an automatic execution could not occur at that price.<sup>162</sup> This is the only instance when automatic executions would be suspended on one side of the market. Autoquote would continue, and orders and cancellations would update the Display Book system.<sup>163</sup> Automatic executions would resume when a bid or offer within the MLRP range is autoquoted or the MLRP range changes as a result of the moving 30-second timeframe.<sup>164</sup>

## *B. Role of the Specialist in the Hybrid Market*

### 1. Specialist Algorithms

The Exchange proposes to allow specialists to participate automatically in the Hybrid Market and replicate the performance of certain specialist privileges and obligations in an electronic way. For instance, specialists would be permitted to establish electronic connections to the Display Book system that would provide them with access to certain information before other market participants, and be permitted to make a range of specified quoting and trading decisions based on that information.

Specifically, the Exchange proposes to provide specialists with the ability to implement systems that use proprietary algorithms, based on predetermined parameters, to electronically participate in the Hybrid Market ("Specialist Algorithm").<sup>165</sup> The Specialist Algorithm would communicate with the Display Book system via an Exchange-owned external application program interface ("API").<sup>166</sup> The Specialist Algorithm is intended to replicate electronically some of the activities specialists are permitted to engage in on the floor in the auction market, and to facilitate specialists' ability to fulfill their obligations to maintain a fair and orderly market.

The Specialist Algorithm would receive information via the API, including information about orders entering NYSE systems, before that information is available to other market participants.<sup>167</sup> NYSE systems would enforce the proper sequencing of incoming orders and algorithmically-generated messages.<sup>168</sup> The Specialist Algorithm and the specialists on the floor would not have the ability to affect

the arrival of orders at the Display Book system, or the sequence in which orders and algorithmically-generated messages are processed by the Display Book system.<sup>169</sup> The Specialist Algorithm, however, would be able to generate certain specified quoting and trading messages based on the information it receives through the API. Once an algorithmic message has been generated, it cannot be stopped, changed, or cancelled on its way to the Display Book system.

The Display Book system would not accept algorithmically-generated messages from the Specialist Algorithm when automatic executions are unavailable except in certain specified situations.<sup>170</sup> Specifically, when automatic executions are suspended, but Autoquote is active, the Display Book system would accept algorithmically-generated messages from the Specialist Algorithm to generate a bid or offer that improves the Exchange BBO or supplements the size of the existing BBO.<sup>171</sup>

In addition, when Autoquote and automatic executions are suspended, the Display Book system would: (1) Process algorithmically-generated messages to layer specialist interest outside the published Exchange quotation and (2) permit specialists to manually layer specialist interest at prices within a previously established locking or crossing quotation.<sup>172</sup>

Furthermore, the Display Book system would not process algorithmically-generated messages from the Specialist Algorithm during the time a block size transaction involving orders in the Display Book system is being manually reported<sup>173</sup> or when the messages would trigger the automatic execution of an AL order or an AM order, or would result in such order's execution with an existing contra-side specialist bid or offer.<sup>174</sup> However, the Display Book system would process algorithmically-generated messages from the Specialist Algorithm to provide price improvement to AL and AM orders in accordance with the price improvement parameters described below.<sup>175</sup> Algorithmically generated messages would not be permitted to create a

<sup>165</sup> See proposed NYSE Rule 104(b).

<sup>166</sup> In Amendment No. 8, the Exchange clarified that specialists would develop Specialist Algorithms to communicate with the Display Book system via the API.

<sup>167</sup> The Specialist Algorithm would have access to the following information: (1) Specialist dealer position; (2) quotes; (3) information about orders in the Display Book system such as limit orders, percentage orders, stop orders, and AL orders and market orders not designated for automatic execution ("AM orders") ("state of the book"); (4) any publicly available information the specialist firm chooses to supply to the algorithm, such as the Consolidated Quote stream; and (5) incoming orders as they are entering NYSE systems. The Specialist Algorithm would not have access to the following types of information: (1) Information identifying the firms entering orders, customer information, or an order's clearing broker; (2) floor broker agency interest files or aggregate floor broker agency interest available at each price; or (3) order cancellations, except for cancel and replace orders. See proposed NYSE rule 104(c)(ii).

<sup>168</sup> See proposed NYSE Rule 104(b)(ii)(A).

<sup>169</sup> See proposed NYSE Rule 104(b)(ii)(B).

<sup>170</sup> See proposed NYSE Rule 104(c)(vi).

<sup>171</sup> See proposed NYSE Rule 104(c)(vi)(i); See also Amendment No. 8.

<sup>172</sup> See proposed NYSE Rule 104(c)(vi)(ii) and 104(c)(viii); See also Amendment No. 8.

<sup>173</sup> See proposed NYSE Rule 104(c)(v).

<sup>174</sup> See proposed NYSE Rule 104(c)(vii) and *infra* Section II(D).

<sup>175</sup> See proposed NYSE Rule 104(c)(vii).

<sup>157</sup> See proposed NYSE rule 1000(a)(iv)(B)(iii).

<sup>158</sup> See proposed NYSE Rule 1000(a)(iv)(B).

<sup>159</sup> See Second Notice, *supra* note 8. See also *supra* note 148.

<sup>160</sup> See proposed NYSE Rules 60(e)(iii) and 1000(b); see also Amendment No. 8.

<sup>161</sup> See *id.*

<sup>162</sup> See proposed NYSE Rule 1000(c); see also Amendment No. 8.

<sup>163</sup> See *supra* note 148.

<sup>164</sup> See *id.*

locked or crossed market<sup>176</sup> and would have to comply with all SEC and NYSE rules, policies, and procedures governing specialist proprietary trading.<sup>177</sup>

#### (a) Quoting Messages

The Exchange proposes to allow the Specialist Algorithm to generate quoting messages to: (1) Supplement the size of the existing Exchange BBO; (2) place within the Display Book system specialist reserve interest at the Exchange BBO; (3) layer within the Display Book system specialist interest at varying prices outside the Exchange BBO;<sup>178</sup> (4) establish the Exchange BBO; and (5) withdraw previously established specialist interest at the Exchange BBO.<sup>179</sup>

A quoting message would not be able to interact with the order that preceded it. In addition, the Specialist Algorithm could move its quote away from the inside market only after the order it is reacting to has been processed.

#### (b) Trading Messages

The Exchange proposes to allow the Specialist Algorithm to generate trading messages to: (1) Provide “additional specialist volume” to partially or completely fill an order at the Exchange BBO;<sup>180</sup> (2) match better bids and offers published by other market centers where automatic executions are immediately available; (3) provide price improvement to an order, subject to the conditions outlined below; and (4) trade with the Exchange published quotation “that is, “hit bids” or “take offers.”<sup>181</sup>

The generation of algorithmic messages to trade in response to a

particular order does not guarantee that the specialist would be able to interact with that order or that the specialist has priority in trading with that order.<sup>182</sup> For example, specialist interest may not trade with the order identified by the algorithmic message because the specialist’s message did not arrive in the Display Book system in time or the specialist has to yield to the Book. Such interest would be automatically cancelled.<sup>183</sup>

#### (1) Specialists’ Ability To Systematically Price Improve Incoming Orders

The Specialist Algorithm would enable specialists, on behalf of their dealer accounts, to electronically provide price improvement to all or part of a marketable incoming order, including an AL order or AM order,<sup>184</sup> provided the following conditions are met: (i) The specialist is represented in a “meaningful amount” in the bid with respect to price improvement provided to an incoming sell order, or in the offer with respect to price improvement provided to an incoming buy order; and (ii) the price improvement provided by the specialist is (a) at least three cents where the quotation spread is more than five cents, (b) at least two cents where the quotation spread is three, four, or five cents, or (c) one cent where the quotation spread is two cents.<sup>185</sup> NYSE proposes to define the term “meaningful amount” as at least 1,000 shares for the 100 most active securities on the Exchange based on average daily volume and at least 500 shares for all other securities on the Exchange.<sup>186</sup> Specialist systematic price improvement would only be available for incoming orders that are marketable (*i.e.*, that can trade with the published bid or offer).<sup>187</sup>

<sup>182</sup> See proposed NYSE Rule 104(c)(i)(C).

<sup>183</sup> See proposed NYSE Rule 104(c)(i)(D).

<sup>184</sup> Specialist Algorithms could price improve AL orders and AM orders, consistent with the requirements noted above, by generating a message to trade with the AL or AM order before it is processed by the Display Book system, or executing the AL or AM order at its quoted price once the order has been processed by the Display Book system. Algorithmic messages that would trigger the automatic execution of AL or AM orders or that would result in such orders trading with the specialist’s existing contra-side bid or offer would be prohibited. See proposed NYSE Rule 104(c)(vii).

<sup>185</sup> See proposed NYSE Rule 104(e)(i)(A)–(D).

<sup>186</sup> See proposed NYSE Rule 104(e)(ii); see also Amendment No. 8. NYSE would disseminate a list of the 100 most active securities on a quarterly basis, or more frequently as the Exchange may determine from time to time. See proposed NYSE Rule 104(e)(ii).

<sup>187</sup> See proposed NYSE Rule 104(e)(i). With respect to incoming orders that are not marketable (*i.e.*, those orders that would establish a new best bid or best offer), the specialist could not trade with such order until the new bid or offer is publicly disseminated.

In addition, the Exchange proposes to amend NYSE Rule 123A.30 to provide for systematic conversion of marketable CAP–DI orders previously entered with the specialist to allow these orders to participate on parity with the specialist when the specialist is price improving an incoming order.<sup>188</sup>

#### (2) Specialists’ Ability To Hit Bids or Take Offers

Specialists’ messages to trade with the Exchange published quote must include information that indicates the quote has been publicly disseminated.<sup>189</sup> In addition, to ensure that a specialist’s algorithmic message to trade with the Exchange published quotation does not possess any speed advantage in reaching the Display Book system, Exchange systems would process such messages in a manner that gives specialists and other market participants a similar opportunity to trade with the Exchange’s published quotation, by delaying the processing of this type of trading message from the Specialist Algorithm.<sup>190</sup>

#### 2. Limitations on Members’ Trading Because of Customers’ Orders—NYSE Rule 92

NYSE Rule 92(a) generally prohibits members from causing the entry of an order to buy (sell) any Exchange-listed security for any account in which such member is directly or indirectly interested, if the person responsible for entering such order has knowledge of any particular unexecuted customer’s order to buy (sell) such security which could be executed at the same price. The Exchange has proposed to amend NYSE Rule 92 to reflect the operation of the Specialist Algorithm.

Specifically, NYSE proposes that the specialist would not be deemed to have knowledge about a particular incoming order that is viewed by the Specialist Algorithm until such incoming order is “processed” by the Specialist Algorithm.<sup>191</sup> According to the Exchange, there may be times when the Specialist Algorithm could “possess” more than one order at the same time.

<sup>188</sup> See proposed NYSE Rule 123A.30(a)(iii).

<sup>189</sup> See proposed NYSE Rule 104(c)(i)(A).

<sup>190</sup> See proposed NYSE Rule 104(b)(ii). Based upon the average transit time from the Common Message Switch (CMS) system to the Display Book system, the Exchange would determine the appropriate amount of time to delay the processing of algorithmic messages to trade with the Exchange published quotation. The delay parameter would be adjusted periodically to account for changes to the average transit time resulting from capacity and other upgrades to Exchange systems. See Third Notice, *supra* note 11.

<sup>191</sup> See proposed NYSE Rule 92.15. See also Amendment No. 7.

<sup>176</sup> See proposed NYSE Rule 104(c)(iv).

<sup>177</sup> See proposed NYSE Rule 104(c)(iii). NYSE has represented that prior to the rollout of the third phase of the Hybrid Market, it will develop guidance to clarify how it expects specialists to comply with the NYSE Rule 104 in the Hybrid Market. Telephone call between Catherine R. Kinney, President and Co-Chief Operating Officer, NYSE Group, Inc. and Richard G. Ketchum, Chief Regulatory Officer, NYSE Regulation, Inc., and Kelly M. Riley, Assistant Director, Division, SEC, on March 22, 2006. See also Amendment No. 8.

<sup>178</sup> In Amendment No. 8, NYSE proposes to permit specialists to manually place interest in the specialist interest files at and outside the BBO. Such interest would remain in the Display Book system until it is traded with or cancelled. See proposed NYSE Rule 104(c)(viii); see also Pilot.

<sup>179</sup> See proposed NYSE Rule 104(b)(i)(A)–(E).

<sup>180</sup> Specialists could supply additional trading volume at the BBO beyond the amount in the specialist’s reserve, if any. The Exchange proposes to amend NYSE Rule 104 to provide that this additional volume, which is not part of the reserve and which is not displayed, could complete an order, thereby providing a single-priced execution, or partially fill the remainder of the order. See proposed NYSE Rule 104(b)(i)(F). Additional specialist volume would yield to displayed and reserve interest.

<sup>181</sup> See proposed NYSE Rule 104(b)(i)(F)–(I).

In addition, there could be times when a permissible algorithmic message has been generated, but before such message has been processed by the Display Book system, the Specialist Algorithm has “read” or “is reading” a new incoming order. This new order could be priced at the same price as the algorithmically-generated order or otherwise be able to trade with the order to which the algorithmic message reacted, but, as a result of proper time sequencing within the Display Book system, the algorithmic message would be processed before the new incoming order. NYSE has proposed to amend Rule 92 to provide that, if the Specialist Algorithm is designed and operated in a manner that prevents a quoting or trading message generated in response to an order from being affected by the receipt of a subsequent order, then for purposes of Rule 92, the specialist would not be deemed to have knowledge of the subsequent order.<sup>192</sup>

### 3. Policy for Communicating With the Specialist Algorithm

NYSE proposes to permit specialists on the floor to control the Specialist Algorithms.<sup>193</sup> For example, specialists could activate or deactivate the firm’s algorithms or adjust the firm’s pre-set parameters that guide an algorithm’s decision-making.<sup>194</sup> Specialists would not, however, have the ability to prevent the processing by the Display Book system of an algorithmically-generated message. NYSE proposes to allow specialists to interact with the Specialist Algorithm via a wired or wireless device that has been registered with the Exchange, such as a computer terminal or laptop. Each specialist firm would be required to certify, in the time, frequency, and manner prescribed by the Exchange, that such wired or wireless devices operate in accordance with all SEC and Exchange rules, policies, and procedures.<sup>195</sup> In addition, specialists would be required to create and maintain records of all messages generated by the firm’s wired or wireless devices.<sup>196</sup>

### 4. Specialist Algorithm Record Requirements

Every algorithmically-generated message generated by the Specialist Algorithm would have to include a code identifying the reason for the algorithmic action (e.g., “match ITS,” “price improvement,” “hit bid,” etc.),

the unique identifiers of the order to which the algorithmically-generated message is reacting (if any), the order immediately preceding the generation of the algorithmically-generated message, and any other information the Exchange may require.<sup>197</sup> The Exchange would automatically cancel algorithmically-generated messages that are unable to interact with the order or quotation identified by the message, where the reason code and the proposed algorithmic action are inconsistent, where message activity would create a locked or crossed market, where the identifiers described above are not included, and in other similar situations.<sup>198</sup>

Furthermore, the Exchange would require that each specialist firm maintain an electronic log of all algorithmically-generated messages, including the date and time of each algorithmically-generated message and such other information as the Exchange shall designate.<sup>199</sup> Such log would have to be maintained in accordance with SEC and Exchange rules regarding books and records, and be capable of being provided to the Exchange upon request, in such time and in such format as the Exchange shall designate.<sup>200</sup> In addition, each specialist firm would be required to notify the Exchange in writing, within such time as the Exchange shall designate, whenever its Specialist Algorithm or an individual algorithm is not operating and the time, cause, and duration of such non-operation.<sup>201</sup> Finally, each specialist would be required to have an independent third party auditor review, on an annual basis, all Specialist Algorithms to ensure that they operate in accordance with all SEC and Exchange rules, policies, and procedures.<sup>202</sup>

### C. Proposal To Make Direct+ Permanent

Direct+ was originally approved as a one-year pilot program ending on December 21, 2001.<sup>203</sup> The pilot was subsequently extended for five

additional one-year periods, and is currently scheduled to end on December 23, 2006.<sup>204</sup> The Exchange proposes to make Direct+ permanent.<sup>205</sup>

### D. Auction Limit Orders and Auction Market Orders

While NYSE has proposed to significantly increase the availability of Direct+, it would still retain its auction market on the floor. Investors would be able to submit orders to floor brokers for representation on the floor (or in the electronic market if the floor broker sends this interest to the floor broker agency interest file). Investors also would be able to submit certain order types electronically through DOT that would be represented by the specialist to seek price improvement opportunities.

Specifically, NYSE has proposed one new order type—AL orders, and has proposed to amend its rules governing the execution of market orders that are not designated as auto ex eligible, i.e., AM orders.<sup>206</sup> Specialists would represent these orders in the auction market, where the Crowd or Auto Ex Orders could offer an opportunity for execution at a price better than the Exchange BBO, while retaining as a backup the possibility of automatic execution in case the floor is unable to offer price improvement promptly.

Under the proposal, AL and AM orders would be automatically executed when they arrive at the Display Book system if the Exchange quotation is at the minimum variation of one cent.<sup>207</sup> Where a better bid (offer) is published by another ITS participating market center in which an automatic execution is immediately available and such better bid (offer) creates a minimum variation market compared with the Exchange best offer (bid), an AL or AM order (or the requisite portion thereof) would be automatically routed to such other market center for execution, unless the

<sup>204</sup> See Securities Exchange Act Release Nos. 45331 (January 24, 2002), 67 FR 5024 (February 1, 2002); 46906 (November 25, 2002), 67 FR 72260 (December 4, 2002); 48772 (November 12, 2003), 68 FR 65756 (November 21, 2003); 50828 (December 9, 2004), 69 FR 75579 (December 17, 2004); and 53014 (December 22, 2005), 70 FR 77228 (December 29, 2005).

<sup>205</sup> This would also have the effect of superseding four filings that have been approved by the Commission during the Direct+ pilot, which were made part of the pilot. See Securities Exchange Act Release Nos. 47024 (December 18, 2002), 67 FR 79217 (December 27, 2002); 47353 (February 12, 2003), 68 FR 8318 (February 20, 2003); 47463 (March 7, 2003), 68 FR 12122 (March 13, 2003); and 47614 (April 2, 2003), 68 FR 17140 (April 8, 2003).

<sup>206</sup> See proposed NYSE Rule 13.

<sup>207</sup> See proposed NYSE Rule 123F(a)(i)(A) and (b)(ii)(A).

<sup>192</sup> See *id.*

<sup>193</sup> See proposed NYSE Rule 36.30.

<sup>194</sup> See *id.* See also proposed NYSE Rule 104(g).

<sup>195</sup> See proposed NYSE Rule 36.30; see also Amendment No. 8.

<sup>196</sup> See *id.*

<sup>197</sup> See proposed NYSE Rule 104(c)(i).

<sup>198</sup> See proposed NYSE Rule 104(c)(i)(D).

<sup>199</sup> See proposed NYSE Rule 104(f)(i). NYSE Rule 132A requires members and member firms to synchronize the business clocks they use to record dates and times of any event the Exchange requires to an Exchange-designated time source.

<sup>200</sup> See *id.*

<sup>201</sup> See proposed NYSE Rule 104(f)(ii)

<sup>202</sup> The Exchange would have the right to request originals and copies of any report, notes, analysis, documents, and similar types of materials prepared by the independent auditor. See proposed NYSE Rule 104(h); see also Amendment No. 8.

<sup>203</sup> See Securities Exchange Act Release No. 43767 (December 22, 2000), 66 FR 834 (January 4, 2001).

specialist matches the price of the better away offer (bid).<sup>208</sup>

If not automatically executed or routed away upon entry, AM orders to buy and AL orders to buy with a limit price that is at or above the Exchange best offer when they reach the Display Book system would be autoquoted the minimum variation better than the Exchange best bid, thereby becoming the Exchange best bid.<sup>209</sup> Similarly, AM orders to sell and AL orders to sell with a limit price that is at or below the Exchange best bid when they reach the Display Book system would be autoquoted the minimum variation better than the Exchange best offer, thereby becoming the Exchange best offer.<sup>210</sup> The size associated with the bid or offer would be the size of the AL or AM order.<sup>211</sup> The size of subsequent AL and AM orders on the same side of the market would be aggregated in the bid (offer) and executed based on time priority, consistent with AL orders' limit prices.<sup>212</sup>

An AL or AM order could miss the market while attempting to obtain price improvement,<sup>213</sup> but according to the Exchange, electronic representation should limit that possibility. Once on the Book, an AL or AM order could participate in any execution, including automatic executions and sweeps. Furthermore, if an AL or AM order has not been executed within 15 seconds after reaching the Display Book system, it would automatically execute (*i.e.*, buy orders would execute against the displayed offer, and sell orders would execute against the displayed bid),<sup>214</sup> provided Autoquote and automatic executions are available.<sup>215</sup> In addition, three events would cause automatic execution of an AL or AM order before 15 seconds has elapsed. The three events are: (i) The arrival of a subsequent order at a better price on the same side of the market as an AL or AM order; (ii) the execution of an order on the same side of the market as an AL or AM order that exhausts some or all of

the displayed contra-side volume available in the Exchange quotation; and (iii) the cancellation of some or all of the displayed contra-side volume, or the improvement of the displayed contra-side price that creates a minimum variation market or allows execution of the AL or AM order with price improvement.<sup>216</sup> In these situations, the order causing the AL or AM order to automatically execute would trade first.<sup>217</sup> If a trade that causes an automatic execution of an AL or AM order also elects stop orders and CAP-DI orders, the AL and AM orders would execute first because they are executable at the time of entry (but seek an opportunity for price improvement), and CAP-DI and stop orders would execute after the AL and AM orders because they are contingent orders that are not executable until elected.

An AL order to buy with a limit price that is not at or above the Exchange best offer when it reaches the Book or an AL order to sell with a limit price that is not at or below the Exchange best bid when it reaches the Book, would be displayed on the Book at its limit price.<sup>218</sup> An AL order that is unable to automatically execute because of its limit price would be handled as a regular limit order.<sup>219</sup>

#### E. Other Changes

##### 1. Intermarket Sweep Order

To implement the requirements of Regulation NMS,<sup>220</sup> the Exchange proposes to amend NYSE Rule 13 to adopt another new order type—the Intermarket Sweep order. An Intermarket Sweep order would be a limit order designated for automatic execution in a particular security that meets the following requirements: (1) It is identified as an Intermarket Sweep order in the manner prescribed by the Exchange; and (2) simultaneously with the routing of the Intermarket Sweep order to the Exchange, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bids (offers).<sup>221</sup> These additional routed orders would have to be marked as intermarket sweep orders. Intermarket Sweep orders would be automatically executed upon receipt against the displayed bid (offer) and would then sweep the Display Book system. Any

portion not executed would be immediately and automatically cancelled. Intermarket Sweep orders would be identified as such on the Consolidated Tape.

##### 2. Record of Orders/Order Tracking

The Exchange proposes in NYSE Rule 123(e) that no order may be represented for execution on the floor or placed in a floor broker agency interest file within the Display Book system unless certain details of the order and the floor broker agency interest file have been first recorded in an electronic system on the floor. Furthermore, the floor member would have to identify which orders or portions thereof are being made part of the floor broker agency interest file. Since NYSE Rule 123(e)(7) provides that the type of order be designated and recorded, the Exchange proposes that AL orders and auto ex market orders be added to this rule.

NYSE Rule 132B prescribes requirements and procedures with respect to orders in any security listed on the Exchange received or originated by a member. It requires a member to immediately record data elements as detailed in the rule. If an order is transmitted to another member or is transmitted to another department of the same member, or is modified or cancelled, information detailed in the rule must be recorded. Additionally, the recipient of the order must record the order details as provided in the rule.

The Exchange proposes similar changes to NYSE Rule 132B(b)(9) with regard to the designation of an order as in proposed NYSE Rule 123(e)(7). Furthermore, NYSE Rule 132B(a)(1)(D) is proposed to be amended to require that members and member organizations identify which orders or portions thereof are being made part of the floor broker agency interest file pursuant to such procedures as required by the Exchange. This would conform NYSE Rule 132B with changes made to NYSE Rule 123(e).

##### 3. NYSE Rule 91

NYSE Rule 91 includes transaction confirmation requirements in instances in which the specialist participates in a transaction as both principal and agent. The Exchange sought and received Commission approval<sup>222</sup> of its interpretation that NYSE Rule 91 does not apply where the specialist is the contra-party to an automatic execution, as the specialist does not accept an Auto Ex Order for execution or act as agent in the execution of such order. NYSE

<sup>208</sup> See proposed NYSE Rule 123F(a)(i)(B) and (b)(ii)(B).

<sup>209</sup> See proposed NYSE Rule 123F(a)(ii) and (b)(iii).

<sup>210</sup> See *id.*

<sup>211</sup> See *id.*

<sup>212</sup> See *id.*

<sup>213</sup> See proposed NYSE Rule 123F(a)(iv) and (b)(v).

<sup>214</sup> See proposed NYSE Rule 123F(a)(iii)(D) and (b)(iv)(D).

<sup>215</sup> If another market displays a price better than the AL or AM orders, the Exchange would execute the AL or AM order at a price (consistent with the AL order's limit) that matches the immediately accessible better away quote. See proposed NYSE Rule 123F(a)(i)(C) and (b)(ii)(C); see also Amendment No. 8.

<sup>216</sup> See proposed NYSE Rule 123F(a)(iii)(A)–(C) and (b)(iv)(A)–(C).

<sup>217</sup> As noted above, a Specialist Algorithm trading message cannot cause the automatic execution of an AL or AM order. See proposed NYSE Rule 104(c)(vii).

<sup>218</sup> See proposed NYSE Rule 123F(a)(v).

<sup>219</sup> See *id.*

<sup>220</sup> 17 CFR 242.600(b)(30).

<sup>221</sup> See proposed NYSE Rule 13.

<sup>222</sup> See *supra* note 203.

proposes to extend this interpretation to its Hybrid Market.

#### F. Hybrid Market Implementation Plan

The Exchange proposes to implement the Hybrid Market in five phases over a period of months.<sup>223</sup> The Exchange believes that this would help ensure proper functioning of the Exchange, specialists, floor brokers, vendor-based systems, and Hybrid Market-related functionalities, and would promote the seamless integration of Hybrid Market facilities into the marketplace. In addition, the phased implementation plan would provide time for market participants to become familiar with the different functions and features, so that they would be adequately prepared to employ them properly once the Hybrid Market is fully functional. Within each phase, the various functions that would become operational during that phase would be made available over a period of several weeks.

In Amendment No. 8, the Exchange committed to provide notice to its members and others using its facilities, through information memoranda and its Web site, of the specific rules that would be effective during each phase.

#### 1. Phase 1—Floor Broker Agency Interest Files, Specialist Interest Files, and Systematic Integration of Priority, Parity, and Yielding Requirements

During the first phase of implementation, the Exchange contemplates activating the floor broker agency interest file to permit floor brokers to enter their interest at or outside the BBO. This would enable floor brokers to gain experience using this tool. Floor brokers would be able to populate the reserve file; however, the reserve file would be visible to the specialist in this phase. The feature permitting floor brokers to exclude their interest from the aggregate information

available to the specialist would not be available in this phase; the Exchange contemplates making the exclusion feature operational in Phase 4. In addition, commencing in Phase 4, floor broker reserve interest would not be visible to the specialist if chosen as an option by the floor broker.

Specialists would be able to manually layer their interest at and outside the BBO during the first phase. However, they would not be able to disseminate this information via OpenBook or another Exchange data distribution channel until Phase 4. The API would not be activated during Phase 1; accordingly, specialists would not be able to use Specialist Algorithms to layer their interest or to otherwise trade or quote, nor would the specialists' reserve capability be operational.

During Phase 1, the systematic programming of priority, parity, and yielding requirements, other than the yielding requirements for additional specialist interest, would be completed, enabling "G" order interest to be included in the floor broker agency files and to be handled by the Display Book system. Other system changes would be made to enhance systematic reporting of transactions and associated audit trail, such as eliminating specialist responsibility for allocation of volume in automatic executions.<sup>224</sup> Finally, the Exchange would implement the automation of CAP-DI orders and stop or stop limit orders.

During Phase 1, Direct+ would continue to operate as it does under the current rules and would be subject to the same restrictions and availability as set forth in NYSE Rules 1000–1005. Accordingly, the Exchange anticipates that most trading would continue to be effected in the auction market, subject to the same rules and conditions as trading on the Exchange today. The Exchange began testing the Phase 1 functions for 168 securities in the Pilot.<sup>225</sup> Upon approval of the Hybrid Market, the Exchange would implement Phase 1 for all its securities.<sup>226</sup>

#### 2. Phase 2—API and Specialist Algorithms

Phase 2 would see the introduction of the API and Specialist Algorithm. During this phase, the specialist's systematic trading and quoting abilities would become operational. For example, the specialist would be able to provide algorithmic price improvement pursuant to the formula described in the

proposal, regardless of the size of the incoming order. Algorithmic trading with the bid and offer, algorithmic ability to make new bids and offers and to withdraw previously made bids and offers, to add size to an existing bid and offer, to match better bids and offers away, and to layer specialist interest at prices outside the BBO, would also be available. Specialist reserve file capability and the yielding requirements for additional specialist interest would become operational during this phase.

As in Phase 1, Direct+ would continue to operate according to the same restrictions and availability as set forth in NYSE Rules 1000–1005 today, and the Exchange anticipates that most trading would continue to be effected in the auction market.

#### 3. Phase 3—Automatic Routing of Orders, Elimination of Direct+ Restrictions, "Slow" Market Indicators, and Gap Quoting

During Phase 3, the following changes would be implemented:

- Automatic routing of orders to automated markets posting better bids and offers in accordance with Regulation NMS;
- Availability of NYSE IOC orders for automatic executions;
- Use of indicators to identify quotations that are not immediately available for automatic executions;
- Implementation of gap quoting procedures;
- Elimination of size restrictions for automatic executions;
- Elimination of 30-second restriction on the entry of Auto Ex Orders from the same person;
- Availability of automatic executions through the close;
- Elimination of Direct+ availability only to straight limit orders;
- Elimination of Direct+ suspensions due to price (*i.e.*, a trade at a price that would be more than five cents from the last trade in the stock on the Exchange);
- Elimination of Direct+ suspensions due to size (*i.e.*, a 100-share published bid or offer);
- Conversion of marketable limit orders automatically to Auto Ex Orders; and
- Automatic executions of designated market orders.

Not all of these features would be made available at the same time during this phase, but instead would be made available in all securities over a period of time.

#### 4. Phase 4—Floor Broker Reserve Features, Sweeps, LRPs, and New Order Types

Phase 4 would implement the following:

<sup>223</sup> See Amendment No. 8. In Amendment No. 8, the Exchange modified the implementation plan by moving: (1) Floor brokers' ability to exclude their interest in the floor broker agency interest file from the aggregate information available to the specialist from Phase 2 to Phase 4; (2) the ability of floor brokers to hide their reserve interest from the specialist from Phase 2 to Phase 4; (3) the specialist's ability to disseminate information regarding its layered interest via OpenBook or another Exchange data distribution channel from Phase 2 to Phase 4; (4) the availability of sweeps, LRPs, and AL/AM orders from Phase 3 to Phase 4; (5) the availability of Intermarket Sweep orders and use of indicators to identify executions involving an Intermarket Sweep order from Phase 3 to Phase 4; and (6) the implementation of new Display Book system templates and programming that will eliminate the suspension of Autoquote and automatic executions from Phase 4 to Phase 5, and by adding: (1) The specialist's ability to manually enter reserve interest to Phase 4 and (2) the availability of IOC (consistent with Regulation NMS) orders for automatic executions to Phase 4.

<sup>224</sup> See NYSE Rule 1001(a)(3).

<sup>225</sup> See Pilot. See Section II(G), *supra*, for a discussion of the Pilot.

<sup>226</sup> See Amendment No. 8.

- Use of indicators to identify an execution involving an Intermarket Sweep order;
- Floor brokers' ability to exclude interest, including reserve, from the aggregate information available to the specialist;
- Sweep functionality for automatic executions;
- Activation of LRP's (both sweep and momentum), and the publication via OpenBook or another Exchange data distribution channel of the most restrictive LRP;
- Availability of new order types—AL and AM orders and Intermarket Sweep orders;
- Specialists' ability to disseminate their layered interest via OpenBook or another Exchange data distribution channel;
- Specialists' ability to manually enter reserve interest; and
- Availability of IOC orders for automatic executions.

#### 5. Phase 5—New Reporting Templates and Elimination of Suspensions of Autoquote and Automatic Executions

In Phase 5, NYSE proposes to implement the new Display Book system templates and programming that would eliminate the suspension of Autoquote and automatic executions.

#### G. Limited Hybrid Market Pilot

As noted earlier, the Commission approved the testing of certain functions the Hybrid Market on December 14, 2005, on a limited basis and for a pilot period expiring on March 24, 2006.<sup>227</sup> The Pilot implemented testing, with respect to a limited group of securities, the specialist interest files, the floor broker agency interest files, and the priority, parity, and yielding rules as proposed in the Hybrid Market.<sup>228</sup>

Specifically, the Pilot allows specialists to manually layer their proprietary trading interest outside the NYSE BBO into the Display Book system.<sup>229</sup> Specialists' proprietary interest remains in the Display Book system until cancelled or executed. The Pilot also allows floor brokers to electronically represent their customers' orders in the floor broker agency interest files.<sup>230</sup> Floor brokers could enter interest in the floor broker agency interest files directly either at the BBO or outside the BBO and could enter

reserve size at the BBO so long as 1,000 shares are displayed. In addition, the Pilot automates the priority, parity, and yielding rules. The Pilot permits specialists to trade on parity with orders represented by floor brokers when specialists are increasing or decreasing their position and eliminates floor brokers' ability to object to specialist parity. Finally, the Pilot implemented the automation of CAP-DI orders and stop orders.<sup>231</sup>

#### III. Summary of Comments and NYSE's Response

The Commission received a total of 43 comment letters on the Hybrid Market proposal.<sup>232</sup> In addition to the amendments filed by the Exchange that addressed many questions raised in the comment letters, NYSE also filed the Response to Comments to address other specific concerns raised in the comment letters.<sup>233</sup>

A few commenters supported the NYSE's proposal to create a Hybrid Market.<sup>234</sup> Several commenters generally supported further automation of the NYSE market,<sup>235</sup> and some of these commenters claimed that the Exchange had not gone far enough to create the automated market that Exchange users desire.<sup>236</sup> A few commenters expressed dissatisfaction with the proposal.<sup>237</sup> Some of these commenters believed that the Exchange failed to create a genuine hybrid market that would blend floor-based and screen-based trading, that the proposed market did not provide for any true inter-market competition, and that it gave preferential treatment to specialists and/or floor brokers.<sup>238</sup>

<sup>231</sup> In Amendment No. 8, the Exchange represented that it has not encountered any systematic difficulties in connection with the Pilot.

<sup>232</sup> See *supra* notes 6, 9, 12, and 13.

<sup>233</sup> See Response to Comments, *supra* note 14.

<sup>234</sup> See IBG Letter II, Invictus Letter, and Power Letter.

<sup>235</sup> See, e.g., Ameritrade Letter, IBG Letters I and II, ICI Letters I, II, and III, SIA Letters I, II and III, STANY Letter, Telic Letter, and Vanguard Letter. However, one commenter suggested that while the proposal could turn out well for liquid stocks, the Exchange should consider separate and distinct rules for illiquid securities. See Bear Stearns Letter.

<sup>236</sup> See, e.g., ICI Letters I and III and Telic Letter.

<sup>237</sup> See, e.g., Bloomberg Letters I and II, IBAC Letters I, II, and III, Peake Letter I, Rutherford Letters I, II, III, IV, V, VI, VII, VIII, IX, and X, Telic Letter, Torino Letter, and Weeden Letter. See also Fidelity Letter III (urging the Commission to consider a study indicating that NYSE's Hybrid Market would be a substantially more costly trading environment than that of fully electronic markets). However, see also Lipson Letter (stating that the data does not justify Fidelity Letter III's conclusion).

<sup>238</sup> See, e.g., Bloomberg Letter I, IBAC Letters I and II, Rutherford Letters I, III, and V, Telic Letter, Weeden Letter. In particular, one of these commenters argued that specialists and floor

Initially, most commenters had questions about the rules that the Exchange had proposed. Specifically, in response to the First Notice, a majority of commenters requested that NYSE provide more details and specific trading examples showing how the Hybrid Market proposal would work.<sup>239</sup> Several commenters raised specific issues. For example, several commenters on the First Notice questioned how the LRP's would work,<sup>240</sup> how specialists would participate in the Hybrid Market,<sup>241</sup> how the floor broker agency interest file would interact with orders on the Book,<sup>242</sup> and how AL and AM orders would be handled.<sup>243</sup> In addition, several commenters requested more detail on automatic execution.<sup>244</sup> Specifically, commenters requested detail on how the priority and parity rules would operate with the specialist interest file and floor broker agency interest file,<sup>245</sup> and the instances when automatic executions would not be available.<sup>246</sup>

Several commenters also questioned how the Hybrid Market would interact with other markets. For example, one commenter questioned whether ITS would be capable of handling NYSE's increased interaction with "away markets" and whether the Exchange had a contingency plan to ensure that adequate linkages will be in place to accommodate the enhancement to

brokers in the proposed Hybrid Market should not be able to charge floor brokerage commission on any orders that are executed automatically in the Display Book system and not by the specialist or floor broker personally. See Rutherford Letter I. Another commenter was concerned that NYSE's ultimate plans would be to move past any true "hybrid" and phase out the auction market entirely, which the commenter believed would disadvantage the investing public that relies on the face-to-face interaction on the floor to achieve the best prices. See IBAC Letters I and II.

<sup>239</sup> See, e.g., Ameritrade Letter, Angelides Letter, Bear Stearns Letter, Bloomberg Letter I, BSE Letter, Fidelity Letters I and II, IBG Letter I, ICI Letter I, Instinet Letter, Peake Letter, SIA Letter I, STANY Letter, and Telic Letter. After the Second and Third Notices, a few commenters continued to believe that the proposal did not fairly and accurately describe exactly what the NYSE intended, and still had explicit questions relating to the Hybrid Market. See also Bloomberg Letter II, IBAC Letters I and II, and Rutherford Letters I, II, III, and V.

<sup>240</sup> See IBG Letter I and ICI Letter I. The Commission notes that NYSE did not specifically define the parameters of its MLRP in the First Notice.

<sup>241</sup> See IBG Letter I and ICI Letter I.

<sup>242</sup> See IBG Letter I and ICI Letter I.

<sup>243</sup> See IBG Letter I.

<sup>244</sup> See BSE Letter, Fidelity Letter I, and STANY Letter.

<sup>245</sup> See Fidelity Letter I, SIA Letter I, and STANY Letter.

<sup>246</sup> See BSE Letter, Instinet Letter, and STANY Letter.

<sup>227</sup> See Pilot Extension, *supra* note 27.

<sup>228</sup> See also Pilot Amendment, *supra* note 27.

<sup>229</sup> Prior to the Pilot, specialists could only manually place their proprietary trading interest at the NYSE BBO.

<sup>230</sup> Prior to the Pilot, floor brokers could only enter their customers' orders in the Display Book system through the specialist.

Direct+.<sup>247</sup> Other commenters questioned how the Hybrid Market would operate in compliance with the ITS trade-through rule or the then-proposed Regulation NMS.<sup>248</sup>

The Exchange responded to the initial comments in its Amendment Nos. 2 and 3, which the Commission published as the Second Notice.<sup>249</sup> In addition to providing more detail on its proposal, NYSE submitted detailed trading examples to demonstrate how its proposed Hybrid Market would operate.<sup>250</sup> Soon after the Second Notice was published, the Commission repropounded its Regulation NMS.<sup>251</sup> Commenters generally asked the Commission to refrain from acting on NYSE's proposal until it had made a decision on Regulation NMS to allow commenters to consider the operation of the Hybrid Market in conjunction with Regulation NMS.<sup>252</sup> Several commenters, however, raised specific concerns about NYSE's proposal as described in the Second Notice. For example, commenters questioned whether it would be appropriate to allow undisplayed floor broker interest to trade on parity with displayed orders on the Book,<sup>253</sup> whether it would be appropriate to allow specialists to have access to non-public information about incoming orders,<sup>254</sup> and whether the sweep functionality would result in less favorable executions of customer orders.<sup>255</sup>

After the Third Notice, certain commenters continued to question several aspects of the proposal that they believed raised investor fairness and logistical issues.<sup>256</sup> Some of these

commenters encouraged the Exchange to modify its proposal to give priority to investor orders and to encourage the display of limit orders.<sup>257</sup>

A number of commenters emphasized the significance of NYSE's proposal.<sup>258</sup> In fact, one commenter stated that NYSE's proposal was "among the most significant SRO rule changes that the Commission has had to evaluate for quite some time."<sup>259</sup> Although the same commenter favored a quick approval and implementation of the proposal,<sup>260</sup> other commenters cautioned the Commission to proceed slowly in considering the NYSE's rule change, to give the industry and investors an opportunity to gain a full understanding of the proposal's effect.<sup>261</sup> Some commenters believed that Direct+ should be subject to a pilot program or have a phase-in period so that there would be an opportunity to review the impact of the proposed changes before they become a permanent fixture of the equities markets.<sup>262</sup>

In its response, the Exchange stated that the proposed enhancements to Direct+ were responsive to customer requests for greater electronic access to the liquidity on the Exchange. The Exchange believed that this, along with the new opportunities for price improvement via AL and AM orders, would make for a better market, would encourage the display of liquidity, and would allow customers to access this liquidity in the manner that best suits their needs. In response to commenters' concerns over the implementation of the Hybrid Market, the Exchange proposed, in the Third Notice, to launch the Hybrid Market proposal in phases. The Exchange believes this phased implementation should help ensure the proper functioning of market participants' Hybrid Market-related systems, promote the integration of Hybrid Market facilities into the marketplace, and allow market participants adequate time to become familiar with the features of the Hybrid Market.<sup>263</sup>

competition and unfairly discriminate against floor brokers and investors), ICI Letter III, Rutherford Letters IV, V, VI, VII, VIII, IX, and X, and Vanguard Letter.

<sup>257</sup> See, e.g., ICI Letter III and Vanguard Letter.

<sup>258</sup> See Fidelity Letter I, IBG Letter I, and Weeden Letter.

<sup>259</sup> See IBG Letter I.

<sup>260</sup> See IBG Letter II.

<sup>261</sup> See, e.g., Angelides Letter, Bear Stearns Letter, SIA Letter I, and Weeden Letter. A few commenters believed that the Commission should hold a public hearing on the proposal. See, e.g., Angelides Letter, Fidelity Letter I, IBAC Letter II, and STANY Letter.

<sup>262</sup> See, e.g., Bear Stearns Letter, Invictus Letter, SIA Letter III, and STANY Letter.

<sup>263</sup> In addition, as noted above, the Exchange implemented a limited pilot to begin testing some

### *A. Liquidity Available for Automatic Executions*

Several commenters argued that off-floor participants should be able to place liquidity on the Display Book system without the use of a floor member.<sup>264</sup> Two commenters argued that the NYSE's proposal failed to provide any material inducement to non-NYSE liquidity providers to participate in the Hybrid Market.<sup>265</sup> One of these commenters stated that the proposal would "perpetuate asymmetric information between specialists, floor brokers and customers that only serves to discourage competing liquidity providers \* \* \*" from providing better prices and more liquidity.<sup>266</sup>

#### *1. Specialist Interest File and Specialist Reserve*

As discussed earlier, specialists would have the ability to manually and systematically place in the Display Book their dealer interest at prices at or outside the Exchange BBO.<sup>267</sup> In addition, a specialist would be able to maintain undisplayed reserve interest on behalf of its dealer account at the Exchange BBO, provided that the specialist displayed at least 2,000 shares at that price on the same side of the market.<sup>268</sup> Specialist interest at the Exchange BBO would be disseminated; specialist reserve would not be disseminated. In addition, specialist interest away from the Exchange BBO could be disseminated, at the option of the specialist, via the NYSE's OpenBook data feed.

Many comments questioned the appropriateness of creating an undisplayed interest file for those market participants that have a time and place advantage relative to the rest of the marketplace.<sup>269</sup> One commenter advised that the Exchange either continually monitor the specialist's dealer position in real time to preclude unlawful trading activity or require the specialist interest file to yield to all orders in all instances.<sup>270</sup>

of its Hybrid Market systems and to give its floor members an opportunity to utilize its functionality in live trading. See discussion of the Pilot in Section II(G), *supra*.

<sup>264</sup> See Rutherford Letters I and V, ICI Letter III, and Vanguard Letter. But see ICI Letter II (noting that it did not object to the Exchange providing floor brokers with the ability to represent their customers as they do today).

<sup>265</sup> See Telic Letter and Weeden Letter.

<sup>266</sup> See Telic Letter.

<sup>267</sup> See proposed NYSE Rule 104(b)(i) and 104(c)(viii).

<sup>268</sup> See proposed NYSE Rule 104(d)(i).

<sup>269</sup> See, e.g., Bloomberg Letters I and II, Rutherford Letters I, III and V, and SIA Letter I.

<sup>270</sup> See Rutherford Letter I.

<sup>247</sup> See, e.g., STANY Letter. See also Ameritrade Letter (voicing concern that Direct+ and ITS would fall short of today's technological standards and create a slow, automated trading environment for listed securities).

<sup>248</sup> See, e.g., Ameritrade Letter, Bloomberg Letters I and II, BSE Letter, Fidelity Letters I and II, and SIA Letter I. See note and accompanying text for a complete discussion of the comments on this issue.

<sup>249</sup> See note 8, *supra*.

<sup>250</sup> The Commission published these trading examples as Exhibit A to the Second Notice.

<sup>251</sup> See Securities Exchange Act Release No. 50870 (December 16, 2004), 69 FR 77424 (December 27, 2004).

<sup>252</sup> See, e.g., ICI Letter III, Nasdaq Letter, and SIA Letters II and III. See also Ameritrade Letter. A few commenters also urged the Commission to examine the Hybrid Market proposal alongside Regulation NMS. See, e.g., Angelides Letter, Fidelity Letter II, Nasdaq Letter, and SIA Letters I, II and III.

<sup>253</sup> See Rutherford Letter II and Invictus Letter.

<sup>254</sup> See Rutherford Letter II, Invictus Letter, and ICI Letter II.

<sup>255</sup> See Rutherford Letter II. See also Bloomberg Letters I and II.

<sup>256</sup> See, e.g., IBAC Letters I and II (arguing that the Commission should reject the Hybrid Market proposal because it lacks the statutorily required information on possible impacts on competition and because the proposal would indeed impair

The Exchange responded that it believes that the specialist interest file would allow specialists to provide value by committing capital and layering the Display Book system outside the BBO. According to NYSE, such interest would benefit the marketplace by increasing liquidity at prices outside the BBO, bridging temporary gaps in supply and demand, dampening volatility, and potentially improving clean-up prices. Additionally, the Exchange noted that specialists would have the option to display all of their specialist interest file away from the BBO in the aggregate price/volume information disseminated via NYSE OpenBook.

#### (a) Specialists' Parity

The Exchange also has proposed to amend its Rule 108 to provide that the specialist interest file would be entitled to trade on parity with interest in the floor broker agency interest files regardless of whether the specialist is increasing or decreasing its position. Specialist interest would, however, continue to yield to orders on the Book. Three commenters opposed these proposed changes to NYSE Rule 108.<sup>271</sup> Two believed that placing specialist proprietary trading on parity with investors' orders would misalign the interests of participants on the Exchange and likely contribute to the ineffectiveness of the Hybrid Market.<sup>272</sup> The other commenter considered this change to be a contravention of the specialists' negative obligation to trade only when reasonably necessary to maintain a fair and orderly market.<sup>273</sup> According to this commenter, specialist parity acquisitions would amount to unnecessary dealer intervention because there would be no market "necessity" for the specialist to effect proprietary trades in these situations, where public

orders could otherwise fully satisfy contra-side interest.<sup>274</sup>

In response, the Exchange noted that, under current practice, floor brokers in the Crowd may permit the specialist to be on parity with their orders. The Exchange stated its belief that parity provides an incentive for specialists to participate in the price discovery process at the point of sale, and has the beneficial effects of dampening volatility and lowering execution costs for investors. In response to the concern that a specialist trading on parity when establishing or increasing its position could be inconsistent with the negative obligation, the Exchange clarified that the general negative obligation incorporated into NYSE Rule 104.10 would continue to apply to all specialist trading on the NYSE.<sup>275</sup>

#### 2. Floor Broker Agency Interest Files and Reserve

NYSE proposes to permit floor brokers to participate in the Hybrid Market by allowing them to systematically provide liquidity at varying prices at or outside the BBO with respect to orders the broker is representing, but only while standing in the Crowd.<sup>276</sup> While a floor broker's agency interest, except reserve, would be displayed as part of the quotation when it is at the BBO, floor broker agency interest outside of the BBO would not be displayed. NYSE proposes to allow floor broker agency interest to trade on parity with the specialist interest file,<sup>277</sup> and in many cases, with orders on the Book.

The Commission received one comment letter criticizing the requirement that floor brokers be physically present in the Crowd to place interest in its floor broker agency interest file.<sup>278</sup> Most of the other

comments regarding floor broker agency interest file focused on the Exchange's proposal to not require the display of such interest that is outside of the BBO while providing this interest with the ability to trade on parity with displayed interest.<sup>279</sup> Specifically, several commenters questioned the fairness of allowing non-displayed floor broker agency interest to trade on parity with disclosed orders on the Book.<sup>280</sup> Some commenters argued that this practice would be inconsistent with the Exchange's goal of providing incentives to place limit orders on the Exchange, and predicted that investors would be reluctant to place limit orders on the Book knowing that they might not be fully rewarded for displaying those orders.<sup>281</sup>

Commenters also expressed the opinion that the proposal appeared to be designed to preserve the time and place advantages that floor members currently enjoy over public investors.<sup>282</sup> For example, one commenter believed that, by authorizing this parity structure, the Exchange would be affording the floor broker agency interest file with three major execution advantages over orders on the Book: (1) Floor broker agency interest entered later in time could deny an execution to public limit orders

response to this criticism, the Exchange explained that, like the current floor today where a floor broker has to be in the Crowd to participate in the auction, the floor broker agency interest file was designed to allow the floor broker to continue participation in the auction, but in an automatic execution environment. In addition, the Exchange believes that the range of five contiguous panels in the proposed definition of a Crowd represents the appropriate range of proximity to enable brokers to also participate in the auction market. Furthermore, the Exchange pointed out that, if a floor broker must leave the Crowd and therefore cancel its agency interest file, the broker could ensure that its customers' orders are still represented in that Crowd by sending such orders to the specialist, sending the orders to Direct+ via its handheld devices for automatic execution, or transferring the orders to another member for representation in the Crowd. In Amendment No. 8, NYSE proposes to limit this restriction by allowing a floor broker to leave the Crowd to recharge a handheld device without canceling its agency interest file.

<sup>279</sup> See, e.g., Bloomberg Letters I and II, ICI Letters I, II, and III, Rutherford Letters I, II, III, and V, SIA Letter I, STANY Letter, and Vanguard Letter.

<sup>280</sup> See, e.g., Bloomberg Letters I and II, ICI Letters I, II, and III, Rutherford Letters I, II, III, and V, SIA Letter I, STANY Letter, and Vanguard Letter.

While supporting the NYSE's proposal to have the floor broker's undisplayed reserve interest at the BBO yield to displayed interest at that price, one commenter questioned why the Exchange did not extend this concept to its execution priorities at other levels of the book. See ICI Letter II.

<sup>281</sup> See, e.g., ICI Letters II and III, Rutherford Letters II and V, STANY Letter, and Vanguard Letter.

<sup>282</sup> See, e.g., Bloomberg Letters I and II, ICI Letters I, II, and III, Rutherford Letters I, II, and III, and SIA Letter I.

<sup>271</sup> See IBAC Letters I and II, ICI Letter III, and Rutherford Letters III, IV, V, VI, VII, VIII, IX, and X. Two of these commenters also challenged NYSE's interpretation of NYSE Rule 108 that provides that specialists can trade on parity with orders in the Crowd when establishing or increasing their position, provided that the floor broker or its customer does not object. See, e.g., IBAC Letter I and Rutherford Letters III, IV, V, VI, VII, VIII, IX, and X.

<sup>272</sup> See IBAC Letters I (also contending that it would increase volatility in the market) and II and ICI Letter III.

<sup>273</sup> See Rutherford Letters III, IV, V, VI, VII, VIII, IX, and X. According to the commenter, since Section 11A of the Act promotes the objective of public order interaction without dealer intervention, specialist parity acquisitions would constitute an example of unnecessary dealer intervention and could not be reconciled with Section 11A. See Rutherford Letter III. See also IBAC Letter I.

<sup>274</sup> See Rutherford Letters III, IV, V, VI, VII, VIII, IX, and X.

<sup>275</sup> See also note *infra* and accompanying text.

<sup>276</sup> However, as noted earlier, a floor broker would be permitted to leave the Crowd without canceling its agency interest files to recharge its handheld device. See proposed NYSE Rule 70.20(f).

<sup>277</sup> The specialist interest file would only trade on parity with the floor broker agency interest file when there are no orders on the Book executable at a particular price.

<sup>278</sup> See Invictus Letter. This commenter believed that the proposed requirement that a floor broker agency interest file be cancelled when the floor broker leaves the Crowd and the proposed definition of a Crowd would be at odds with the direction of technology, greater speed, productivity, and liquidity. Because floor brokers are equipped with hand held computers and can act in a virtual capacity at any post where they have customer interest files, this commenter believed that limiting them to a distance of five contiguous panels at the same post would be arbitrary and unnecessarily restrictive and would put customers who use independent floor brokers at a disadvantage. In

entered earlier in time;<sup>283</sup> (2) floor broker agency interest would often be entitled to superior parity splits with the Book, since the proposed parity structure would treat the Book as only one bidder (irrespective of the number of orders on the Book, the aggregate number of shares, and their times of entry);<sup>284</sup> and (3) floor brokers would enjoy an informational and order entry advantage that will allow them to “see” the orders on the Book and make trading decisions by entering floor broker agency interest.<sup>285</sup>

Accordingly, commenters insisted that for a floor broker agency interest file to be on parity with other orders at its price, a broker should be required to display orders placed in their agency interest file in the same manner as at the BBO.<sup>286</sup> If the Exchange believes that floor brokers’ agency interest should be undisplayed, commenters argued that those orders should not be provided parity with fully-displayed orders on the Book.<sup>287</sup>

One commenter suggested that the Exchange give qualified customers the option either to give their agency interest to a floor broker or enter it directly in the Display Book system themselves.<sup>288</sup> Similarly, with respect to a floor broker’s ability to place

undisplayed reserve interest at the BBO, two commenters suggested that the Exchange provide investors with a similar reserve feature where investors would have the direct ability to conceal a portion of their orders at the BBO, and not be required to do so solely through the use of a floor broker.<sup>289</sup> One of these commenters argued that this aspect of the proposal would not support economically efficient executions or the ability of investors to interact directly, and thus would be inconsistent with the principles of section 11A under the Act.<sup>290</sup>

In general support of the floor broker agency interest file, the Exchange stated that this feature would allow customers both to take advantage of floor broker knowledge and trading expertise, as well as the efficiencies of automatic executions. The Exchange believes that floor brokers would be able to use the interest file to effectively represent interest that their customers do not wish to display, and, simultaneously, permit this interest to be accessed by incoming orders and participate in automatic executions and sweeps.

Furthermore, in addressing comments that undisplayed floor broker agency interest should not trade on parity with displayed orders on the Book, the Exchange proposed in Amendment No. 6 to revise the standing of orders on the Book and floor broker agency interest during a sweep. Specifically, the Exchange proposes to revise NYSE Rule 70 to provide that during a sweep, the amount of floor broker agency interest that would have been displayed had there been a new quote at the clean-up price would trade on parity with displayed interest, *e.g.* orders on the Book, at that price. The amount of any floor broker agency interest that would have been placed in the broker’s reserve would yield to displayed interest. The Exchange believes that this amendment is consistent with the concept that displayed interest at each price point would execute before non-displayed interest at the same price point and the corollary principle that non-displayed interest at a better price would trade ahead of displayed interest at a worse price, while taking into account the fact that during a sweep there is no opportunity for floor broker agency interest at the clean-up price to be displayed before an execution that occurs at that price.<sup>291</sup>

With respect to suggestions that the floor broker agency interest file would provide floor brokers with some form of advantage over public customers, the Exchange emphasized that floor brokers would only have access to information pertaining to their own agency interest, and no access to other broker’s files. Similarly, the Exchange proposed that neither specialists on the floor nor the Specialist Algorithms would have access to any information about specific orders in floor broker agency interest files.<sup>292</sup> Under the proposal, specialists would only be able to view the total aggregated broker agency interest at each price, except for any interest a broker has elected to not disclose to the specialist.

Furthermore, in response to comments questioning the reserve feature of the floor broker agency interest file and whether it would grant too much advantage to floor brokers,<sup>293</sup> the Exchange argued that the existence of reserve interest would not be unique to the Exchange, and that electronic order books in other markets have a reserve functionality at all price levels, not just the BBO.<sup>294</sup> In the Hybrid Market, the Exchange believes that the reserve functionality would allow floor brokers to use their skills to determine the best way to represent their customers’ interests, whether that be through the display of some or all of the customer order. Furthermore, the Exchange believes that the reserve feature would benefit the marketplace as a whole by providing liquidity and dampening price volatility. Since reserve interest would yield to

(*i.e.*, no one would be aware of the floor broker agency interest file except for the floor broker since the interest would not actually be displayed prior to a sweep transaction). Accordingly, the commenter believed that the amendment would not attract liquidity or solve the problems of unfairness to the Book, since investors with orders on the Book would still have no information about interest in the floor broker agency interest files.

<sup>292</sup> Only the specialist on the floor would have access to limited information pertaining to interest in the files. The specialist would not know the number of customer orders behind such volume, who the orders are for, which brokers represent the orders, or the limit prices for such orders. See Response to Comments, *supra* note 14.

<sup>293</sup> See, *e.g.*, Bloomberg Letters I and II, ICI Letter III, Rutherford Letter I, SIA Letter I, and Vanguard Letter.

<sup>294</sup> However, see Rutherford Letter V. This commenter argues that markets with reserve features are, for the most part, non-primary, non-price discovery markets whose lack of transparency does not materially impact the overall price discovery process. However, the commenter believes that the critical distinction between other markets that have reserve features and the NYSE’s proposed Hybrid Market is that there is not a similar concept of “parity” in those markets (*e.g.*, a trader cannot enter a reserve order in those markets that will supersede the price/time priority of a previously entered order).

<sup>283</sup> See Rutherford Letters III and V. This commenter believed that the proposal would allow floor brokers to enter interest in reaction to their knowledge of public orders on the Book, and thereby supersede the clearly established price/time priority of such public limit orders. The commenter believed this to be fundamentally unfair to public investors and unknown in other major securities markets. See Rutherford Letter V.

<sup>284</sup> This commenter believed that the Exchange’s examples do not reveal the fact that the Book would be deemed to be only one “bidder” regardless of how many individual orders are on the Book at the same price, while every broker who enters an agency interest file would be considered a separate “bidder.” See Rutherford Letter V. This commenter believed that, if the floor broker agency interest file is permitted to compete directly with the price/time priority of the Book, it should be treated as only one bidder. See Rutherford Letter I.

<sup>285</sup> See Rutherford Letters I, III, and V (also claiming that Amendment No. 6 failed to address the floor brokers’ informational advantage in placing orders and their advantage in being able to supersede the price/time priority of orders on the Book and in being treated as a separate “bidders,” whereas limit orders on the Book would be treated as one “bidder”). The commenter also argued that the principal beneficiary of the clean up methodology would be undisplayed floor broker agency interest files, which could be entered on the Display Book with knowledge of, and in relation to, the limit orders on the Book to take advantage of possible sweep executions.

<sup>286</sup> See, *e.g.*, ICI Letters I, II and III, Rutherford Letters I and II, SIA Letter I, and Vanguard Letter.

<sup>287</sup> See, *e.g.*, ICI Letters I, II and III (recommending that the Exchange provide execution priority on the same level as fully displayed investors’ orders only to the portion of those orders represented by the floor brokers that are displayed). See also SIA Letter I.

<sup>288</sup> See Rutherford Letters I and III.

<sup>289</sup> See, *e.g.*, ICI Letters I and III and Vanguard Letter.

<sup>290</sup> See Vanguard Letter.

<sup>291</sup> However, see Rutherford Letter V. This commenter argued that the NYSE’s revision in Amendment No. 6 to the standing of floor broker agency interest during a sweep would be ineffective

displayed interest at the Exchange BBO, but would participate in automatic executions at that price provided there is sufficient contra-side liquidity, the Exchange believes that reserve interest would benefit incoming orders by providing more liquidity at the BBO, yet without disadvantaging displayed interest at the BBO. The Exchange believes that it would be unable to attract and aggregate liquidity as effectively if a reserve feature was not offered, as it is in other competing market centers. In response to comments that investors should have a similar feature to directly enter interest in reserve, the Exchange represents that the reserve feature would be available to all investors through floor brokers. Customers seeking to participate in the reserve interest field would be able to do so by sending their orders to floor brokers with appropriate instructions as to how they want their orders handled. The Exchange believes that creating a reserve feature exclusively for on-floor participants would provide an incentive for participating in price discovery at the point of sale, and would allow differentiation from typical electronic communication network (ECN) functionality.

## B. Automatic Executions

### 1. Sweeping the Display Book System

With respect to sweeps, two commenters noted that incoming investors' orders that sweep the Display Book system would be executed at a clean-up price, which could be inferior to other prices placed in the Display Book system.<sup>295</sup> Specifically, one commenter believed that the proposed sweep methodology would result in executions less favorable to investors than that of the current floor auction, which allows floor brokers with a large order to trade at intervening price levels instead of only a clean-up price.<sup>296</sup> The other commenter questioned whether the Exchange's proposal would be consistent with best execution requirements of brokers.<sup>297</sup>

Two commenters also suggested that the proposed sweep function should be considered in relation to the pilot program in Regulation SHO, *e.g.* the effect a sell short sweep order would have under the pilot where consecutive

bids were hit.<sup>298</sup> In Amendment No. 8, the Exchange proposes in NYSE Rule 1000(d)(iii)(E) to clarify that during a sweep, sell short orders, other than those involving Regulation SHO pilot securities, would have to comply with the conditions outlined in the SEC's Short Sale Rule, Rule 10a-1, and NYSE Rule 440B.

### 2. Automated Routing to Other Markets

Initially, a number of commenters generally believed that the proposal would allow limit orders to be swept on NYSE at prices that are inferior to prices immediately available at other markets.<sup>299</sup> In addition, some commenters initially believed that the proposal did not clearly indicate how a specialist would be able to match the NBBO on an away market, and noted that there did not appear to be a minimum size requirement for specialists to match away markets. Specifically, some commenters thought that the NYSE specialist could program its systems to automatically put up a pre-emptive 100 share bid or offer to match the NBBO at any given time on any other market, and thus would not be obligated to send trades to another market.<sup>300</sup>

In addressing these comments, the Exchange emphasized in its Second Notice and Response to Comments that the proposed Hybrid Market would operate in full conformity with all SEC rules, including Regulation NMS. In response to specific comments that the specialist in the Hybrid Market proposal could trade through better prices on another market center below the NBBO, the Exchange stressed in the Second Notice that the operation of sweeps, including the automatic electronic routing of orders to the market centers displaying better priced bids and offers, would be consistent with the fundamental tenet of the ITS trade-through rule and Regulation NMS—that the best bids and offers published by other market centers are entitled to protection. The Exchange represented that best bids (offers) published by away markets that are better than a clean-up price would be satisfied in their entirety. The Exchange further represented that, as today, best bids and offers in these markets (*i.e.*, “top of the book”) would be entitled to price protection in the Hybrid Market.<sup>301</sup> The

Exchange disagreed with comments suggesting that it should also provide price protection at intervening price levels, and argues that while intermarket price-time priority has been extensively debated, it has not been viewed to be in the best interest of the national market system.

Furthermore, the Exchange pointed out that a specialist already has the option of matching a better published bid or offer rather than shipping an order to that bid or offer. The Exchange believes that the proposed rules would simply make this process more efficient by permitting the specialist to electronically match or ship. During the sweep, a commitment to trade that satisfies the full amount of any better bid or offer that is published as the best bid or offer by another market center would be auto-routed to such market (if a prohibited trade-through would otherwise occur), which the Exchange argues is consistent with the ITS trade-through rule and Regulation NMS.

### C. Availability of Direct+ and Liquidity Replenishment Points

Two commenters supported NYSE's proposal to remove order size and time entry restrictions in Direct+.<sup>302</sup> Commenters, however, requested more detail on when automatic executions would not be available.<sup>303</sup> Specifically, many commenters requested after the First Notice that the Exchange supply additional details and examples regarding the operation of LRPs, including the determination and dissemination of the LRP to the public, the frequency of triggering a LRP, and the specific parameters of a MLRP.<sup>304</sup> Some commenters questioned whether LRPs would be too restrictive or even necessary to dampen volatility, and expressed concern over the length of time LRPs could stop automatic execution in the Hybrid Market.<sup>305</sup> Commenters suggested that the Exchange reexamine the rules governing halts and resumption of trading to ensure that the LRP parameters are realistic.<sup>306</sup> After the Third Notice, one

that would satisfy a protected quote of an away market, unless the specialist matches the better published price.

<sup>295</sup> See, *e.g.*, Bloomberg Letters I and II and Rutherford Letters I, III, and V (declaring that the sweep clean up price methodology would be a benefit only to those trade initiators who seek such a price; otherwise, there is significant economic dislocation for them with respect to the traditional pricing of large orders that cannot be filled at published bid or offer prices).

<sup>296</sup> See Rutherford Letter I.

<sup>297</sup> See Bloomberg Letters I and II.

<sup>298</sup> See Rothenberg Letter and SIA Letter I.

<sup>299</sup> See, *e.g.*, Ameritrade Letter, Bloomberg Letters I and II, Fidelity Letters I and II, and SIA Letter I.

<sup>300</sup> See, *e.g.*, Bloomberg Letters I and II, Fidelity Letter I, SIA Letter I.

<sup>301</sup> As discussed earlier, except for IOC and Intermarket Sweep orders, NYSE proposes to automatically route portions of an Auto Ex Order

<sup>302</sup> See Rutherford Letter III and STANY Letter.

<sup>303</sup> See, *e.g.*, BSE Letter, Instinet Letter, SIA Letter I, and STANY Letter.

<sup>304</sup> See, *e.g.*, Ameritrade Letter, Bear Stearns Letter, BSE Letter, IBG Letter I, ICI Letters I and II, SIA Letter I, and STANY Letter.

<sup>305</sup> See, *e.g.*, Ameritrade Letter, Bear Stearns Letter, ICI Letters I and II, and SIA Letter I. See also SIA Letter III and Vanguard Letter. One of these commenters thought that the parameters of the MLRP could be too restrictive for very liquid stocks. See ICI Letter II.

<sup>306</sup> See, *e.g.*, Ameritrade Letter, ICI Letters I, and Vanguard Letter.

commenter asserted that market volatility should not be artificially limited through the mechanism of LRPs, but that investors should be free to place, and interact with, orders at all price points without unnecessary market center intervention.<sup>307</sup> Another commenter expressed concern about the priority of order execution coming out of an LRP.<sup>308</sup> This commenter wondered if an order that caused the price of a security to reach an LRP would be denied priority coming out of the LRP.

The Exchange described LRPs as pre-determined price points at which electronic trading would briefly convert to auction market trading. With respect to MLRPs, the Exchange believed that excessive volatility could occur in situations other than electronic sweeps and thus proposed a LRP based on price movement over a period of time. The Exchange also described in the Second and Third Notices the specific parameters of MLRPs, and clarified that automatic executions could occur within the MLRP range.

In addressing commenters' concerns over the use of LRPs in the Hybrid Market, the Exchange stated that it believes that LRPs would promote reasonable price continuity and foster market quality. When a LRP converts the market exclusively to an auction market on a temporary basis, the Exchange believes this would provide an opportunity to moderate volatility by permitting new orders, as well as Crowd and specialist interest, to add liquidity. Furthermore, the Exchange represented that the LRP parameters were selected by the Exchange after careful evaluation and discussions with market participants, and have been designed to limit automatic executions infrequently. According to the Exchange, when reached, LRPs would allow buyers and sellers to react to fast-changing market conditions and provide an opportunity for orders to interact with Crowd interest not encompassed in the broker agency interest file and with specialist interest, enabling the auction market to supplement liquidity and lower volatility. In addition, to respond to commenters' requests for more details on LRPs, the Exchange provided additional discussion and examples in the Second Notice, and also set out the timeframes within which automatic executions and Autoquote would resume after a LRP is reached.

Similar to the concerns expressed over LRPs, many commenters also generally questioned the particular methods and frequency of suspensions

of automatic executions in the Hybrid Market.<sup>309</sup> For instance, a few commenters requested that the Exchange provide more information on how often the Exchange could preclude investors from obtaining an automated sweep of the Display Book and the timeframes within which the security would remain in an auction capacity or "slow" mode.<sup>310</sup> Like the comments relating to LRPs, commenters suggested that the proposed rules regarding halts and resumption of trading be examined to ensure that they are structured in a manner to permit the least amount of disruption as possible.<sup>311</sup> One commenter questioned whether NYSE would be considered reopening its market for purposes of Regulation NMS each time a LRP is reached or a specialist has gapped the quote.<sup>312</sup>

In response to these comments, the Exchange represented that Autoquote and automatic executions would be suspended infrequently and only in certain limited circumstances, such as when trading on the Exchange reaches a LRP, when the quote is gapped in accordance with Exchange procedures, when trading in a security has been halted, when the quote is not firm, or when a block size transaction involving orders in the Display Book system is manually reported.<sup>313</sup> The Exchange

believes that suspension of Autoquote and automatic executions to report block trades is necessary to protect customer orders on the Book and facilitate orderly executions in limited "breakout" situations and during the reporting of a block size transaction.

The Exchange will disseminate a systematic indication, consistent with Regulation NMS, when automatic executions against its published quotation are unavailable. In addition, in situations when automatic executions are suspended due to a gapped quote or LRP, NYSE will notify members by way of an indicator that the NYSE quotation is not firm.

The Exchange represented that once the Hybrid Market is implemented, all other instances of manual reporting<sup>314</sup> would not suspend Autoquote and automatic executions, and the quote would automatically update to reflect the entry of better bids and offers and cancellations. Finally, in the Second Notice, the Exchange represented, based on its original proposal which proposed to suspend automatic executions and Autoquote more frequently, that it expected Autoquote and automatic executions to be available at least 99.7% of the time.<sup>315</sup>

#### *D. Role of the Specialist in the Hybrid Market*

##### *1. Specialist Algorithm*

The Exchange proposes to allow specialists to participate automatically in the Hybrid Market by capturing many specialist functions and replicating certain specialist privileges in an electronic environment. As discussed earlier, specialists would be permitted to establish Specialist Algorithms to send specific quoting and trading messages via the API to the Display Book system.

After the First Notice, the Commission received a number of comments questioning the operation of the Specialist Algorithm in the Hybrid Market, including its ability to generate quoting and trading messages on behalf of the specialist's dealer account and the sequence of priority and parity rules with respect to the specialist interest file and incoming orders.<sup>316</sup> Although one

<sup>309</sup> See, e.g., Ameritrade Letter, Bloomberg Letters I and II, BSE Letter, Fidelity Letter I, ICI Letter I, Instinet Letter, SIA Letter I, and STANY Letter.

<sup>310</sup> See, e.g., Fidelity Letter I, and SIA Letter I.

<sup>311</sup> See, e.g., ICI Letter III and Vanguard Letter.

More specifically, several commenters also expressed concern over the suspension of automatic execution when the specialist has gapped the quote. See BSE Letter, ICI Letter I, Nasdaq Letter, and SIA Letter III. In justifying the specialist's use of gapped quotes, the Exchange explained in the Second Notice that gap quotes would be used by specialists in response to trading scenarios in which price dislocation is expected, such as a sudden influx of orders on one side of the market, one or more large-size orders with no off-setting interest, or when a member proposes to effect a one-sided block size transaction or a cross at a significant premium or discount to the prevailing market. In an attempt to mitigate volatility, specialists would use gap quotes to signal the potential price movement so as to attract contra-side liquidity. The Exchange also clarified in the Second Notice that, when the quotation is gapped, automatic executions and Autoquote would be suspended, although incoming orders and cancellations would update the Book electronically. Furthermore, the Exchange explained that better priced orders would be taken into account in the transaction resulting from the gapped quotation and that Floor Officials would oversee the gap quote process, including its duration.

<sup>312</sup> See Nasdaq Letter. The Commission notes that turning off automatic executions, for example, for a gap quoting situation, the triggering of a LRP, or the reporting of a block size transaction, would not in and of itself halt trading and thus trigger a reopening pursuant to Rule 611(b)(3) of Regulation NMS. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005).

<sup>313</sup> Autoquote and automatic executions would resume when the manual reporting is concluded.

<sup>314</sup> For example, trades occurring within the Crowd or between the Crowd and the specialist, as either agent or dealer, are reported manually.

<sup>315</sup> One commenter argued that automatic executions should be available 100% of the time because it is during times when news is disseminated or when there is an imbalance or when there is a fast market that its customers need certainty of execution. See Ameritrade Letter. See also ICI Letter I.

<sup>316</sup> See, e.g., Bloomberg Letter I, BSE Letter, IBG Letter I, ICI Letter I, Peake Letter I, SIA Letter I,

Continued

<sup>307</sup> See Vanguard Letter.

<sup>308</sup> See SIA Letter III.

commenter appeared to support the amendments to NYSE Rule 104 that describe the Specialist Algorithm,<sup>317</sup> several of the comments raised issues of fairness and transparency in the operation of the Specialist Algorithm.<sup>318</sup> Specifically, commenters opposed allowing the Specialist Algorithm to “read” certain information before other market participants and to interact with incoming orders and quotes on the Display Book system based on that information.<sup>319</sup> Two commenters questioned whether the operation of the Specialist Algorithm was consistent with the specialist’s negative and affirmative obligations.<sup>320</sup> One of these commenters opposed providing only the specialists with the ability to trade algorithmically with incoming orders and believed it would greatly increase the specialists’ speed advantage and tilt the playing field toward the specialists and away from the investing public.<sup>321</sup> These two commenters also viewed as ineffective the Exchange’s proposal to delay the processing of algorithmic messages (based on the average transit time from the CMS) to give specialists

and other market participants a similar opportunity to trade with the Exchange’s published quotation.<sup>322</sup>

In support of the API and the Specialist Algorithm, the Exchange asserted that specialists provide significant value to the market: They commit capital to narrow quotes, add liquidity, and stabilize prices.<sup>323</sup> The Exchange maintained that its proposed rules provide specialists with the ability to transmit to the Display Book system algorithmic messages to quote or trade on behalf of their dealer accounts so that they are able to fulfill their market making obligations once electronic trading increases. According to the Exchange, this algorithmically-based trading and quoting would be permissible only in certain, limited ways that preclude the opportunity for abuse. By allowing specialists to do electronically that which they are able to do manually today, the Exchange believes that specialists would be able to continue to provide value and liquidity in the Hybrid Market.

In addressing comments that the specialist’s ability to access certain information and then algorithmically trade and quote based on that information would give the specialist an unfair informational advantage over other market participants, the Exchange said that specialists would need to engage in algorithmic trading to effectively participate in the Hybrid Market and continue to fulfill their market making obligations in an efficient and effective manner. The Exchange contends that, without this ability, specialists in an automated environment would be unable to ensure that there is appropriate price continuity and depth, in which price movements are accompanied by appropriate volume, and that unreasonable price variations between trades are avoided. The Exchange stressed that the Specialist Algorithm would not be privy to any more or different information than specialists currently have today.<sup>324</sup> In the Hybrid

Market, the Specialist Algorithm would be required to function according to new NYSE rules and take predetermined actions before an order arrives at the Display Book system. To do this effectively, the Specialist Algorithm would need to take into account the size and price of an incoming order to determine the appropriate algorithmic action.<sup>325</sup> According to the Exchange, specialists’ algorithmic trading would be strictly controlled and limited to relatively few circumstances as detailed in NYSE Rule 104. The Exchange represents that the requirements detailed in NYSE Rule 104(b)–(h) for algorithmic trading would be enforced systematically, and, in some ways, would be more restrictive than current auction market rules.<sup>326</sup>

For example, to ensure that an algorithmically-generated message to trade with the Exchange published quotation (*i.e.*, to hit a bid or take an offer) does not have an advantage—since the specialist’s system would be aware of an incoming order that would change the BBO before such new bid or offer is publicly disseminated—the processing of the specialist’s algorithmically-generated message would be delayed so as to give all market participants a comparable opportunity to trade with such bid or offer. This would be accomplished by delaying processing of the algorithmically-generated message for a period based upon the average transit time from the system to the Display Book system. According to the Exchange, the delay parameter would be adjusted periodically to account for changes to the average transit time resulting from capacity and other upgrades to Exchange systems.

In addition, per proposed NYSE Rule 104(b)(ii), neither the specialist on the floor nor the messages generated by the Algorithms would have the ability to affect the order in which algorithmically-generated messages and incoming orders are processed by the Display Book system. In correcting one commenter’s impression that orders would have to go through the

STANY Letter, and Telic Letter. *See also* Rutherford Letter III (advising after the Third Notice in response to NYSE’s proposed change to its Rule 92 that the Exchange should program its system so that the specialist’s dealer orders can never be executed ahead of a public limit order that is executable at the same price of the proposed specialist trade).

<sup>317</sup> *See* Invictus Letter (stating that proposed NYSE Rule 104 appears constructive as a potential risk management tool and may speed the process of providing liquidity by specialists). However, this commenter expressed a concern over the potential of piercing the information barrier, whereby the data, within the computers running the algorithms and the staff monitoring the books across all the specialists within a firm, could be communicated outside the Exchange and be seen by upstairs traders or other business units affiliated with the specialists. This commenter believed that there should be an affirmative statement from the Exchange concerning this prohibition. In Amendment No. 8, NYSE clarified that its current information barrier rules would prevent a specialist firm from sharing information with its affiliated business units. Specifically, the Exchange represented that pursuant to NYSE Rule 104(i), Specialist Algorithms would have to be designed to comply with all Exchange rules, policies, and procedures, including NYSE Rule 98, which requires the existence of information barriers between the specialist operations and other business operations in situations where the specialist is part of an integrated firm.

<sup>318</sup> *See, e.g.*, IBAC Letters I and II, ICI Letters I, II, and III, Rutherford Letters I, III, V, and IX, SIA Letters I and III, and Vanguard Letter.

<sup>319</sup> *See, e.g.*, IBAC Letter I, ICI Letters I, II (recommending that the Hybrid Market proposal be amended to make this information available to investors as well), and III, Rutherford Letters I, III, and V, SIA Letters I and III, and Vanguard Letter.

<sup>320</sup> *See* IBAC Letter I and Rutherford Letters I, III, and V.

<sup>321</sup> *See* IBAC Letters I (questioning the effectiveness of NYSE’s solution that floor brokers will be able to mitigate the impact of specialist algorithmic trading by entering bids and offers into the floor broker agency interest file) and II.

<sup>322</sup> *See* IBAC Letter I and Rutherford Letter V.

<sup>323</sup> The Exchange represented that currently specialists provide approximately 9% of total volume, approximately 80% of which is stabilizing in nature. *See* Response to Comments, *supra* note 14.

<sup>324</sup> In response to commenters that argued that specialists would have an informational advantage over other market participants due to their ability to see floor broker agency interest files, the Exchange clarified that specialists would only be able to view the total aggregated floor broker agency interest at each price, except for any interest a broker has elected not to have disclosed to the specialist. The Exchange argued that specialists need to know the amount of buy and sell interest at each price to fulfill their obligation to maintain a fair and orderly market and to determine

appropriate prices in manual trading situations, such as after a quote is gapped or when a LRP has been reached. The Exchange maintains that specialists would thus not be given an advantage over other market participants, as commenters may believe (*See* ICI Letter II). Moreover, the Exchange emphasized that a broker can elect to exclude its agency interest from the aggregate disclosed to the specialist without jeopardizing such interest from participating in automatic executions.

<sup>325</sup> For example, to fulfill their obligations, specialists today have knowledge of incoming orders, as well as CAP and stop orders. *See* Response to Comments, *supra* note 14.

<sup>326</sup> *See also* note *infra* and accompanying text.

specialist's trading system before they are sent to the book for processing.<sup>327</sup> the Exchange clarified that an incoming order would not be delayed in its arrival at, or processing by, the Display Book. A copy of the order would go to the specialist's system, and the actual order would continue on its path to the Display Book for processing.

With regard to commenters' recommendation that the Exchange aggressively monitor the Specialist Algorithm to preclude unlawful trading activity, the Exchange pointed out that algorithmically-generated messages would provide improved audit trail data for NYSE Regulation, since detailed information regarding such messages and the systems within which they operate would be captured systematically. In addition, the rules would require specialists to produce information and documentation regarding their systems that should assist NYSE's oversight of specialists' algorithmic trading.<sup>328</sup> To ensure that the specialists' ability to trade algorithmically is consistent with the expectations of market participants, the Exchange also plans to establish a committee composed of representatives of the various Exchange constituencies that would review the functioning of the Hybrid Market based upon experience and data, including specialist trading data.<sup>329</sup>

## 2. Specialists' Ability To Systematically Price Improve Incoming Orders

Commenters objected to the specialists' ability, on behalf of their dealer accounts, to provide price improvement electronically to all or part of a marketable incoming order.<sup>330</sup> These commenters believed that the specialists' ability to "see" information before others and price improve is fundamentally unfair to other market participants and a disincentive to displaying limit orders.<sup>331</sup> One of these

commenters claimed that the algorithmic price improvement functionality would provide the specialist with a unique proprietary trading opportunity and would be inconsistent with the specialist's negative obligation.<sup>332</sup> This commenter also believed the requirement that the specialist be represented in the quote for a minimum of 1000 shares to price improve would be ineffective, and suggested that the Exchange restrict the specialist to providing algorithmic price improvement only when the incoming order would otherwise trade against the specialist's bid or offer.<sup>333</sup> In addition, two commenters urged the Exchange to provide floor brokers with the functionality to provide price improvement electronically in the current proposal, rather than in a later filing, to promptly level the playing field between specialists and investors.<sup>334</sup>

The Exchange represented that throughout the process of formulating rules governing specialist-provided price improvement, the Exchange has sought to balance the benefit this would provide to incoming customer orders with the interests of customers who have displayed orders at prices inferior (albeit by as little as one cent) to that at which the specialist would be willing to trade, or who would like a similar opportunity to trade with incoming orders. Although comments have criticized the algorithmic price improvement of one cent as "penny-jumping,"<sup>335</sup> the Exchange believes that the ability of the specialist to provide price improvement of one cent when the quotation spread is two cents provides a meaningful benefit to the incoming order, and is consistent with Federal securities laws and Exchange rules, which permit any market participant to bid, offer, or trade one cent (*i.e.*, the minimum variation) better than an existing bid or offer.

In response to comments that other market participants should also have the ability to systematically price improve or trade with incoming orders, the Exchange indicated that it is in the

process of developing the means by which floor brokers would have the ability to do this through a discretionary price capability. In addition, the Exchange proposes to automatically convert CAP-DI orders that are able to trade along with the specialist at the improved price, so that these orders can participate in that execution. The Exchange believes that the opportunity for price improvement is an important factor in market quality and a hallmark of the Exchange, and thus seeks to preserve this important feature in the Hybrid Market.

## E. Auction Limit and Auction Market Orders

Under NYSE's proposal, AL and AM orders would automate the opportunity for investors to seek potential price improvement of a penny or better. The Exchange describes AL and AM orders as market and marketable limit orders that would be exposed to the auction and electronic market and would have the possibility of price improvement. These orders would automatically execute if: (1) The order is not executed within 15 seconds; or (2) a quoting or trading action triggers automatic execution before the 15-second period times out.

After the First Notice, a few commenters had specific questions regarding how AL and AM orders would be processed and handled.<sup>336</sup> These commenters requested clarification and examples relating to the execution of these orders and how they would interact with existing order types, the time priority of these orders when an incoming order triggers their execution, and which participants could trade with these orders. After the Second and Third Notices, another commenter, who supported the current NYSE methodology of price improvement resulting from order competition in the auction market, asserted that the proposed 15-second exposure procedure for price improvement of AL and AM orders would likely result in less price improvement, a risk of price disimprovement, and a greater prospect of orders not even being executed.<sup>337</sup>

In addressing the need for more details, NYSE provided an extensive

<sup>327</sup> See, e.g., SIA Letter III.

<sup>328</sup> For example, proposed Exchange Rule 104(f)(ii) requires that specialists notify the Exchange in writing within such time as the Exchange shall designate, whenever an algorithm is not operating and the time, cause, and duration of such non-operation.

<sup>329</sup> One commenter viewed this aspect of the proposal as a "positive step." See SIA Letter III.

<sup>330</sup> See, e.g., IBAC Letters I and II, ICI Letter III, Rutherford Letters I, III, and V, and Vanguard Letter.

<sup>331</sup> See, e.g., IBAC Letter I, ICI Letters II and III (claiming that their members are much more likely not to post orders on the Exchange due to the ability of specialist to electronically interact with orders through this mechanism), Rutherford Letters I, III, and V (asserting that the specialist algorithmic price improvement to incoming Auto Ex Orders that would otherwise be automatically executed against the contra-side bid or offer has no net public benefit

and discourages the placement of public limit orders on Book), and Vanguard Letter (arguing that if the specialist is willing to provide liquidity at a price that is better than the BBO, then the specialist should be required to display that liquidity).

<sup>332</sup> See Rutherford Letter V (stating that NYSE's approach transforms the specialist from the trader of last resort to the only one who can trade in the first place).

<sup>333</sup> See Rutherford Letter V.

<sup>334</sup> See IBAC Letters I and II (urging the Commission to not approve the Hybrid Market proposal until this functionality is provided to floor brokers) and ICI Letter III.

<sup>335</sup> See, e.g., Rutherford Letter III.

<sup>336</sup> See BSE Letter, IBG Letter I, SIA Letter I, and STANY Letter.

<sup>337</sup> See Rutherford Letters I, III (stating that, given the prospect of inferior pricing, NYSE's proposal effectively gives the specialist an illegal "not held" order, and renders it virtually impossible for broker-dealers with "best execution" responsibilities to seek price improvement on the Exchange), and V (stating that AL and AM orders can be executed at worse prices because later arriving orders could exhaust contra-side liquidity, a result unknown in today's physical auction).

discussion in the Second Notice on AL and AM orders, including how they would be electronically executed when they arrive at the Display Book if the Exchange quotation is at the minimum variation, or routed away to another market center if that market center is publishing the national best bid (offer) and it causes a minimum variation with the Exchange's best offer (bid). The Exchange also clarified that if AL and AM orders are not automatically executed or routed away upon entry, they would be quoted at a price to attract liquidity (a penny better than the Exchange best bid or offer, as applicable) while retaining their limit price. Furthermore, the Exchange clarified in the Second Notice the three events that would cause automatic execution of an AL or AM order before 15 seconds has elapsed,<sup>338</sup> and also provided detailed examples of how AL and AM orders would function in the Hybrid Market.

#### IV. Discussion

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, with the requirements of section 6(b) of the Act.<sup>339</sup> Specifically, the Commission finds that approval of the proposed rule change, as amended, is consistent with section 6(b)(5) of the Act<sup>340</sup> in that the proposal is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission also finds that the proposed rule change is consistent with section 6(b)(8) of the Act,<sup>341</sup> which prohibits an exchange's rules from imposing a burden on competition that is not necessary or appropriate in furtherance of the Act. The Commission believes that the proposed rule change,

as amended, is also consistent with section 11A(a)(1)(C) of the Act,<sup>342</sup> in which Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure: (1) Economically efficient execution of securities transactions; (2) fair competition among brokers and dealers and among exchange markets, and between exchange markets, and markets other than exchange markets; (3) the availability to brokers, dealers, and investors of information with respect to quotations and transactions in securities; (4) the practicability of brokers executing investors' orders in the best market; and (5) an opportunity for investors' orders to be executed without the participation of a dealer.

The adoption of Hybrid Market proposal may fundamentally change the Exchange's current market structure from a floor-based auction market with an emphasis on human contact, to a predominantly electronic market with limited human intervention. Today, the vast majority of orders sent to NYSE for execution are handled manually by NYSE floor members—specialists and floor brokers. Specialists represent orders that are electronically submitted to the Exchange via DOT or left with them for representation by floor brokers. Floor brokers receive their own customers' orders at their booths on the floor that are delivered electronically or by telephone. These floor members represent each order individually in the market, ascertaining the current market by seeking contra-side liquidity.

Trading on NYSE may be considerably different once the Hybrid Market proposal is implemented. Orders that currently are represented individually are more likely to be executed automatically without human intervention.<sup>343</sup> While NYSE has proposed to move to a more automated model, it also seeks to retain substantive roles for its floor members. Specialists will be permitted to perform many of their obligations to maintain a fair and orderly market electronically, while floor brokers will be able to represent their customer orders electronically. To create the Hybrid Market, the Exchange has proposed significant changes to its rules and systems to alter the way specialists, floor brokers, and customers would participate and interact.

As discussed more fully below, the Commission finds that the Hybrid

Market proposal, by allowing greater electronic access to liquidity on NYSE, should help perfect the mechanism of a free and open market. The Hybrid Market proposal should provide investors with a more efficient mechanism to have their orders executed on the Exchange. The Commission also finds that the Hybrid Market should facilitate securities transactions by providing investors with faster access to the trading interest reflected in NYSE's published quotation, as well as interest away from the Exchange BBO.<sup>344</sup> Finally, the Commission finds that the Hybrid Market could enhance the opportunity for a customer's order to be executed without dealer participation, consistent with the goals of the Act.

#### A. Increased Access to Display Book System

Under the proposal, a wide range of additional order types could be entered into Direct+ for automatic execution. For example, all marketable limit orders, designated market orders, designated IOC orders (including ITS Commitments), and Intermarket Sweep orders, would be able to receive automatic execution against interest placed in the Display Book system. In addition, for the first time, Auto Ex Orders would have the ability, within certain limits, to sweep interest outside the Exchange BBO. The proposal also would eliminate the size and the 30-second order entry restrictions that currently limit automated access to the Exchange's quote via Direct+. The Commission finds that the availability of automatic executions for a much wider range of order types, the ability of Auto Ex Orders to sweep the NYSE depth-of-book, and the elimination of the size and timing restrictions for Auto Ex Orders, are consistent with the requirements of the Act. Specifically, the Commission believes that providing more instantaneous access to liquidity on the Display Book system should facilitate the efficient execution of orders on the Exchange and potentially could enhance the ability of executions to occur without the participation of a dealer.

In addition to broadening the scope of automatic executions, NYSE has proposed to limit the instances when Direct+ would not be available.

<sup>338</sup> The three events are: (i) The arrival of a subsequent order at a better price on the same side of the market as an AL or AM order; (ii) the execution of an order on the same side of the market as an AL or AM order that exhausts some or all of the displayed contra-side volume available in the Exchange quotation; and (iii) the cancellation of some or all of the displayed contra-side volume, or the improvement of the displayed contra-side price, creating a minimum variation market or allowing execution of the AL or AM order with price improvement. See proposed NYSE Rule 123F.

<sup>339</sup> 15 U.S.C. 78f(b). In approving this proposal, the Commission has considered the proposed rules' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>340</sup> 15 U.S.C. 78f(b)(5).

<sup>341</sup> 15 U.S.C. 78f(b)(8).

<sup>342</sup> 15 U.S.C. 78k-1(a)(1)(C).

<sup>343</sup> Several commenters generally supported NYSE's move to a more automated trading model. See, e.g., Ameritrade Letter, IBG Letters I and II, ICI Letters I, II, and III, SIA Letters I, II, and III, STANY Letter, Telic Letter, and Vanguard Letter.

<sup>344</sup> The Commission notes that, while it believes the proposed rule change, as amended, is consistent with the requirements of the Act, the Commission makes no determination whether the Hybrid Market would satisfy the "automated trading center" definition in Rule 600(b)(4) of Regulation NMS. See Securities Exchange Act Release No. 51808 (June 9, 2005), 70 FR 37496 (June 29, 2005).

Currently, under NYSE rules, Direct+ is unavailable under many circumstances. Some of these reflect the needs of NYSE's current market structure, which is largely a manual auction on the floor. For example, specialists have broad discretion to disable Direct+ by publishing 100 share quotes and manually reporting floor transactions.<sup>345</sup> When Direct+ is disabled, Auto Ex Orders are directed to the specialist for manual handling in the auction. In addition, NYSE Rule 1000 permits Direct+ to be turned off if a block size transaction away from the NYSE BBO is in the process of being completed on the floor.<sup>346</sup> In such instances, the specialist publishes a quote that is five cents away from the last reported sale, and this has the effect of disabling Direct+.<sup>347</sup> Further, NYSE Rule 1000 permits Direct+ to be turned off if the NYSE quote is not firm, the execution price would be more than five cents away from the last reported transaction price, a better price exists in another ITS market, or trading has been halted.<sup>348</sup>

Under the proposal, Direct+ would be unavailable only when: (1) The NYSE quote is not firm; (2) trading has been halted; (3) the specialist has gapped the quotation in accordance with Exchange procedures; (4) trading has reached a LRP; (5) a block size transaction involving orders in the Display Book system is being manually reported; or (6) an Auto Ex Order is entered for a high-priced security. The Commission believes that these proposed changes should ensure that automatic executions are more readily available on NYSE than they are today.

Further, the Commission believes the proposal should provide specialists with less discretion to disengage Direct+ than they have today. This reduced specialist discretion both should help ensure that automated executions are more widely available on NYSE and help alleviate concerns that specialists might manipulate the automated/non-automated status of NYSE for their own benefit. Specifically, specialists would only be permitted in two instances to actively disengage Direct+: (1) By gapping the NYSE quotation and (2) by manually reporting block size transactions that involve orders on the Display Book system. NYSE believes that the specialist, when faced with a substantial order imbalance, may need

the ability to attempt to attract additional liquidity in a controlled environment without automatic executions. NYSE has sought to ensure that specialists do not frequently enter gapped quotations for the purpose of disabling Direct+ by requiring that when a specialist gaps the quote, it must follow certain procedures and consult with floor officials.<sup>349</sup> Specialists will also be permitted to disengage Direct+ when manually reporting a block size transaction that involves orders on the Display Book system. The Commission believes that this limited ability to disengage Direct+ could be necessary due to the practical difficulties of integrating orders on the Book into large transactions on the floor.

The Commission also believes that the other limited instances when Direct+ will not be available are reasonable. High-priced securities would be ineligible to participate in automatic executions because they are thinly traded and, according to the Exchange, customers would obtain better representation if transactions in these securities are handled in the manual auction market. Finally, when trading is halted or when the NYSE quotation is not firm, no execution, automatic or manual, would be available.

The Commission notes that when Direct+ is disengaged, whether due to an LRP or any of the other events that cause the NYSE market to revert to a manual market, the NYSE quote would not be an "automated quotation," and thus not entitled to protection under Rule 611 of Regulation NMS.<sup>350</sup> When this occurs, NYSE also would be required to immediately identify its quotation as a manual quotation if it is to be considered an "automated trading center" for purposes of Regulation NMS.<sup>351</sup> In addition, when the NYSE quotation is not available for automatic execution because of a LRP or gapped quotation, NYSE would identify such quotes as non-firm. The Commission believes that these requirements may provide an incentive to NYSE to keep the frequency and length of the unavailability of automatic executions to a minimum.

#### 1. Liquidity Replenishment Points

Under the proposal, when trading on the Exchange reaches a LRP, automatic executions would be unavailable and the Hybrid Market would temporarily

revert to an auction market. NYSE has proposed two types of LRPs: (1) The sweep LRP and (2) MLRP. As discussed in Section II(A)(5) above, the sweep LRP price would be set at the nearest five-cent increment outside the NYSE BBO, rounded to the next nickel. The MLRP price would be calculated by adding the greater of \$.25 or 1% of the security's price to its lowest price within a rolling 30-second period and subtracting that amount from the security's highest price within the same time period. In the event that there is no transaction in a security within the 30-second period, the MLRP would be based on the last transaction on the Exchange.

Initially, commenters questioned the specifics of LRPs, including whether they were too restrictive and whether they were necessary.<sup>352</sup> After NYSE proposed the parameters for MLRP, one commenter questioned whether the parameters would cause frequent suspension of Autoquote and automatic execution.<sup>353</sup> Another commenter believed that market volatility should not be artificially limited and that LRPs are too restrictive for active securities.<sup>354</sup>

According to NYSE, the LRPs are intended to moderate volatility, which may increase when the Hybrid Market is implemented and a larger portion of NYSE trades are executed electronically. NYSE believes that reverting to a manual market in times of volatility will enhance the quality of executions in its market.

As noted above, the Commission believes that the increased availability of automated executions should facilitate the efficient execution of orders on the Exchange and enhance the opportunity for executions to occur without the participation of a dealer. NYSE believes, however, that precluding automatic executions under certain circumstances—such as where market volatility has triggered an LRP—will provide its customers with better executions by fully utilizing the expertise of its floor members. In the Commission's view, this type of hybrid market model is consistent with the requirements of the Act, and, as such, is within the realm of judgments generally left to the discretion of individual markets. Creating a new market model also has the potential to foster intermarket competition. Accordingly, the Commission finds that NYSE's use of LRPs in the context of its Hybrid

<sup>345</sup> See NYSE Rule 1000(iv).

<sup>346</sup> See NYSE Rule 1000(v).

<sup>347</sup> In a separate proposal, the Exchange is proposing to require specialists to publish a 100 x 100 share market quote that reflects the last reported transaction in connection with a block size transaction. See *supra* note 134.

<sup>348</sup> See NYSE Rule 1000.

<sup>349</sup> See NYSE Information Memo 04-27. The Commission notes that NYSE must update this information memo to reflect that automatic executions on both sides of the market will be suspended once the quote is gapped.

<sup>350</sup> 17 CFR 242.611.

<sup>351</sup> See 17 CFR 242.600(b)(4)(iii).

<sup>352</sup> See, e.g., Ameritrade Letter, Bear Stearns Letter, BSE Letter, IBG Letter I, ICI Letters I and II, SIA Letter I, and STANY Letter.

<sup>353</sup> See ICI Letter II.

<sup>354</sup> See Vanguard Letter.

Market is consistent with the requirements of the Act.

#### B. Autoquote

NYSE has proposed to disengage its Autoquote system in three specified instances. Specifically, Autoquote would not be available when the specialist gaps the quote, when the specialist is manually reporting a block size transaction that includes orders in the Display Book system, or when an LRP has been reached. The Commission believes that it is consistent with the requirements of the Act to disengage Autoquote for limited periods to accommodate these specific activities in the auction market. For example, in the circumstances when the quote is gapped or an LRP is reached, the Commission believes that Autoquote may be disengaged to permit the specialist to more effectively fulfill its obligation to maintain a fair and orderly market by controlling the NYSE quote during limited periods of significant market activity. Accordingly, the Commission finds that the proposed provisions relating to Autoquote are consistent with requirements of the Act.<sup>355</sup>

#### C. Liquidity Available for Automatic Execution

As discussed in Section II(A) above, NYSE proposes to allow its floor members to post liquidity in the Display Book system electronically, so that it is available for automatic executions. Specifically, NYSE proposes to create two new files within the Display Book system—the specialist interest file and the floor broker agency interest file. Specialists and floor brokers would be allowed to place liquidity within these new files in the Display Book system at the Exchange BBO or outside the Exchange BBO. The liquidity within these interest files would not be disseminated, unless it is priced at the Exchange BBO.<sup>356</sup>

In addition, specialists and floor brokers could enter reserve size at the Exchange BBO. This interest would not be disseminated and would trade after all displayed interest at the BBO has been filled. Specialists would be

required to display at least 2,000 shares at the BBO to enter reserve size, and floor brokers would be required to display 1,000 shares. The Display Book system will automatically replenish specialist interest files and floor broker agency interest files to the minimum displayed amounts, unless there is insufficient reserve size to display the minimums. In such cases, the entire amount of reserve will be added to the displayed size.

The proposed specialist interest file and proposed floor broker agency interest file generated several comments. Generally, commenters raised several broad issues related to the ability of specialists to see interest in the floor broker agency interest files, the lack of display of both reserve interest and floor broker agency interest away from the BBO, and NYSE's requirement that floor brokers remain in the "Crowd" when utilizing the floor broker interest file.<sup>357</sup> Specifically, a number of commenters questioned the lack of transparency of the floor broker agency interest file, given that floor broker interest would not be publicly disseminated unless it were at the NYSE BBO.<sup>358</sup> These commenters argued that the floor broker agency interest file, if not displayed, should not be entitled to trade on parity with displayed orders on the Book.<sup>359</sup>

The Commission finds that NYSE's proposal to allow floor brokers and specialists to electronically participate in the Hybrid Market is consistent with the requirements of the Act. This capability could increase the liquidity available for automatic executions on NYSE. Moreover, including the interest of these floor members and their customers in the Hybrid Market electronically could improve the prices at which Auto Ex Orders that sweep the Display Book system may execute. In addition, the proposal should allow customers of floor brokers to more effectively participate in an electronic trading environment.

The Commission also finds that making floor broker agency interest information available to specialists is consistent with the requirements of the Act. In the Hybrid Market, specialists would continue to have the obligation to conduct the auction on the floor. Thus,

to ensure that all interest is represented in an auction, the Commission believes that a specialist would need full information about the liquidity available and the prices at which such liquidity is available. The availability of this information also may assist specialists in maintaining a fair and orderly market under NYSE Rule 104 and Rule 11b-1 under the Act. Further, floor brokers that do not want specialists to have information about their interest have the discretion to exclude their interest from the aggregate information available to specialists if they believe that doing so is in the best interest of their customers. The Commission also notes that Specialist Algorithms would not be able to view or make quoting or trading decisions based on interest in the floor broker agency file that is not publicly available.<sup>360</sup>

The Commission further finds that the floor broker reserve function is consistent with the requirements of the Act as it could provide floor brokers with greater flexibility in handling and working large customer orders. In particular, the reserve function could prove useful to institutions that wish to minimize the market impact of their large orders. Furthermore, allowing floor brokers to place interest in reserve could increase participation on NYSE, which might enhance the depth and liquidity of NYSE's market. The Commission also believes that it is consistent with the requirements of the Act to allow specialists to place reserve interest in the Display Book system as it too could increase the liquidity available for execution at the Exchange BBO.

Two commenters suggested that NYSE allow investors to place reserve, or undisplayed, interest in the Display Book system.<sup>361</sup> One of these commenters argued that depriving investors of this ability would be inconsistent with the principles set forth in section 11A of the Act.<sup>362</sup> The Commission believes that the decision to limit the availability of reserve orders to specialists and floor brokers, under the conditions proposed by NYSE, is within the realm of judgments generally left to the discretion of an individual market and is consistent with the requirements of the Act. In addition, this aspect of the Hybrid Market is similar to how the NYSE market operates today, as investors today must use a floor member to represent their undisplayed interest on the Exchange.

<sup>355</sup> The Commission notes that the display of customer limit orders is governed by the Limit Order Display Rule, 17 CFR 242.604, and that even if Autoquote is disengaged, specialists may be required to display such orders in compliance with this rule. The Exchange represented that it would notify specialists after an LRP has disengaged Autoquote to alert specialists of their obligations under the Limit Order Display Rule.

<sup>356</sup> Specialists could elect to disseminate their interest via NYSE OpenBook. The specialist would be able to view aggregate floor broker interest at each price level, unless the floor broker elects to exclude its interest from the specialist's view.

<sup>357</sup> As discussed further below, the specialist interest file and the floor broker agency interest file generated comments regarding the priority and parity rules that would be implemented for these files.

<sup>358</sup> See, e.g., Bloomberg Letters I and II, ICI Letters I, II, and III, Rutherford Letters I, II, III, and V, SIA Letter I, and STANY Letter. See also Vanguard Letter.

<sup>359</sup> For a complete description of the parity issues, see *infra* Section IV(D).

<sup>360</sup> See proposed NYSE Rule 104(c)(ii).

<sup>361</sup> See ICI Letters I and II and Vanguard Letter.

<sup>362</sup> See Vanguard Letter.

The Commission notes that two features of NYSE's proposal to allow undisplayed reserve interest should help ensure that market participants continue to have an incentive to display quotes or orders on NYSE: (1) Specialists and floor brokers must display a minimum number of shares at the BBO to have undisplayed reserve interest; and (2) displayed interest will have priority over all undisplayed reserve interest. The Commission believes that, taken together, these requirements could promote additional depth at the Exchange BBO, while preserving incentives for investors to display limit orders. Accordingly, the Commission finds that NYSE's proposal to allow floor brokers and specialists to have undisplayed reserve in the Display Book system is consistent with the requirements of the Act.

NYSE also proposes to require floor brokers to be in the "Crowd" when the floor broker maintains interest in the floor broker agency interest file. NYSE defines a "Crowd" as any five contiguous panels at any one trading post. It would be a violation of Exchange Rules for a floor broker to leave the Crowd without canceling its interest in the file,<sup>363</sup> but if this occurs, the floor broker nevertheless would be held to any resulting executions. One commenter believed that limiting the Crowd to five contiguous panels is arbitrary and unnecessarily restrictive.<sup>364</sup>

The Commission believes that the requirement that a floor broker be present while representing orders in the Display Book system is within the realm of judgments generally left to the discretion of an individual market and is consistent with the requirements of the Act. NYSE has proposed to create a Hybrid Market that combines a manual auction market on the floor with an electronic market. The Commission notes that NYSE currently requires floor brokers to be present in the Crowd to represent their customer orders in the auction market.<sup>365</sup> NYSE stated that it believes five contiguous panels is the appropriate range of proximity to enable floor brokers to electronically participate in the Hybrid Market and, at the same time, physically participate in the auction component of the Hybrid Market. Under these circumstances, the Commission believes that it is reasonable for NYSE to require floor brokers to be available to actively

represent their customers, even when their customers' interest is in the Display Book system, by requiring floor brokers to be present in the Crowd.

#### D. Automatic Executions

Under the proposal, Auto Ex Orders would execute against interest in the Display Book system, including the Book, floor broker agency interest files, and specialist interest files. Auto Ex Orders would first execute against interest at the Exchange BBO. Once interest at the Exchange BBO is exhausted, an Auto Ex Order would trade with interest outside the Exchange BBO, automatically sweeping the Display Book system, until it is: (1) Executed; (2) its limit price, if any, is reached; or (3) a LRP is reached, whichever occurs first. During a sweep, the residual would trade at the clean-up price.

The Commission notes that the ability to sweep the NYSE Display Book system is a significant expansion of the availability of automatic executions on the Exchange. Currently, Auto Ex Orders that are for a size greater than the Exchange BBO trade automatically with the BBO, and then the residual is routed to the specialist for manual handling. The Commission believes that the ability to automatically execute against the depth of interest on the NYSE Display Book system should enhance the speed of executions and facilitate more efficient transactions on the Exchange.

Several commenters raised concerns about the rules NYSE proposed governing how automatic executions would occur against interest in the Display Book system. In particular, commenters raised concerns about how the rules of priority, parity, and precedence would apply with regard to interest in the Display Book system.<sup>366</sup>

Currently, executions on the Exchange are governed by NYSE Rules 72, 104, and 108. When more than one market participant is bidding or offering the best price, these rules detail which participant(s) have the right to fill the order—either entirely, or a certain percentage of it—before anyone else. As a general rule, the first person to quote the price at which the security is ultimately traded is entitled to "priority"—the right to fill the order before anyone else.<sup>367</sup> "Parity," on the other hand, means that none of the market participants competing to fill the

order has rights over any other based on quoting the best price first.<sup>368</sup> Generally, in a situation of this kind, participation in the order must be divided pro rata among the crowd participants who simultaneously bid to fill the order at the best price. To create incentives for market participants to provide liquidity, current Exchange rules may permit certain participants to trade ahead of others who are on parity if they are quoting in size. (This is known as "precedence based on size.")<sup>369</sup>

Specialists are subject to additional restrictions on their ability to trade for their own accounts, given their special position in the marketplace. Specifically, specialists, as agents for orders on the Book, are required to yield to orders on the Book.<sup>370</sup> Today, specialists also are limited, pursuant to NYSE Rules 104 and 108, when trading for their own accounts along with orders represented by floor brokers. NYSE Rules 72 and 104 provide that when a specialist is decreasing or liquidating its position, the specialist is entitled to parity unless requested by a floor broker, on behalf of its customer, to yield. NYSE Rule 108 provides that a specialist is not entitled to parity when increasing or establishing its position, but, according to NYSE, it has interpreted this rule as permitting the specialist to trade on parity when increasing its position, so long as the floor broker consents.<sup>371</sup>

NYSE proposes certain changes to its rules of priority, parity, and precedence. For example, NYSE proposes that the interest in the floor broker agency interest file and specialist interest file trade on parity once all interest in the Book has been satisfied, with neither entitled to priority. To accomplish this, NYSE would prohibit a floor broker from placing any interest in its agency interest file that would restrict the ability of the specialist to trade on parity. In other words, specialists would be entitled to trade on parity with orders represented by floor brokers in the floor broker agency interest file, and floor brokers would not be able to object to such specialist trading.<sup>372</sup> The Exchange also proposes to eliminate the regulatory distinction, in this context, between situations where the specialist is increasing or decreasing its position.

In addition, NYSE proposes to permit the floor broker agency interest file to trade on parity with orders in the Book

<sup>368</sup> See NYSE Rule 72(e).

<sup>369</sup> See NYSE Rule 72(c) and (d).

<sup>370</sup> See NYSE Rule 92.

<sup>371</sup> See *supra* note 101.

<sup>372</sup> If the floor broker does not want the specialist to trade on parity with its customer, it could place its customer's order on the Book.

<sup>363</sup> The floor brokers would be permitted to leave the Crowd to recharge its handheld device. See proposed NYSE Rule 70.20(f).

<sup>364</sup> See *Invictus* Letter.

<sup>365</sup> See, e.g., NYSE Rule 117.10.

<sup>366</sup> See, e.g., Bloomberg Letters I and II, IBAC Letters I and II, IBG Letter I, ICI Letters I, II, and III, Rutherford Letters I, II, III, IV, V, VI, VII, VIII, IX, and X, SIA Letter I, STANY Letter, and Vanguard Letter.

<sup>367</sup> See NYSE Rule 72(a).

to the extent that neither is entitled to priority. At the BBO, floor broker agency interest that is displayed would trade on parity with interest in the Book. During sweeps, floor broker agency interest that is designated as eligible for display if the price moves to the BBO would be permitted to trade on parity with the Book. Floor broker agency interest that would not be displayed even if at the BBO (*i.e.*, reserve interest) would not be entitled to trade on parity with the Book during a sweep at the clean-up price.

These proposed changes generated several comments. For example, three commenters believed that NYSE should not allow specialists to trade on parity with the floor broker agency interest file when specialists are increasing or establishing their position.<sup>373</sup> One commenter argued that allowing specialists to trade on parity with the floor broker agency interest file would be inconsistent with the specialists' negative obligation, as well as section 11A of the Act, which encourages order interaction without the participation of a dealer.<sup>374</sup> Other commenters raised concerns about the ability of undisplayed floor broker interest outside the BBO to trade on parity during sweeps with displayed orders on the Book.<sup>375</sup> For example, some commenters argued that permitting floor brokers to conceal their interest from other market participants, while allowing this undisplayed interest to trade on parity with displayed interest, would provide a disincentive for investors to place limit orders on the Book, since investors would not be rewarded for taking the risk to display their orders.<sup>376</sup>

The Commission's standard for reviewing trading rules filed by exchanges is based on whether the rules are consistent with the requirements of the Act, such as provisions that require that market participants be treated fairly and provisions that limit the role of specialists.<sup>377</sup> The Commission also reviews trading rules to see if the rules discriminate in favor of some members over others, or in favor of members over public customers.<sup>378</sup> Trading rules also must promote fair and orderly markets,

as well as the specified goals of the national market system.<sup>379</sup>

The Commission finds that NYSE's proposal to permit specialists to trade on parity with the floor broker agency interest after interest on the Book has been exhausted is consistent with the requirements of the Act. The Commission notes that specialists will continue to be restricted in their ability to trade pursuant to section 11(b) and Rule 11b-1 of the Act,<sup>380</sup> and NYSE Rule 104. The Commission expects and the Exchange represented that it expects the Specialist Algorithms to be programmed and operated in a manner to ensure that specialist proprietary trading is conducted consistent with section 11(b) of the Act,<sup>381</sup> Rule 11b-1, and NYSE Rule 104.

In accordance with SEC Rule 11b-1, NYSE Rule 104 restricts the specialist's ability to trade for its own account. SEC Rule 11b-1 provides that exchanges may permit members to register as specialists so long as their rules include, among other things, "provisions restricting [the specialist's] dealings so far as practicable to those reasonably necessary to permit [it] to maintain a fair and orderly market \* \* \*". NYSE Rule 104 specifically prohibits a specialist from dealing in its own account "unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market \* \* \*". Currently, the specialist makes the determination as to whether its proprietary transactions are reasonably necessary based on the anticipated needs of the market and the conditions of the market at the time the transaction is effected. As proposed, the specialist may not have access to all of the information that it has today regarding the condition of the market at the time of sale. Specifically, the specialist may not, and the Specialist Algorithm will not, have access to information regarding floor broker reserve at the BBO or floor broker agency interest outside of the BBO. Accordingly, the Commission must consider the application of the restrictions in SEC Rule 11b-1 and NYSE Rule 104 to the specialist's proprietary trading in the Hybrid Market.

In the Hybrid Market, specialists will remain obligated to determine whether

their proprietary trades are reasonably necessary to maintain a fair and orderly market. The specialist will be expected to actively monitor, both personally and through the Specialist Algorithm, whether the interest placed in the specialist interest file remains appropriate in light of current market conditions and the specialist's obligations under NYSE Rule 104, and to make appropriate adjustments. Nonetheless, the Commission recognizes that the role of the specialist in the more automated Hybrid Market will be somewhat different from its traditional role on the Exchange floor. Specifically, the specialist will participate in automatic executions that occur against proprietary interest previously placed in the specialist interest file. The Commission also recognizes that, in the Hybrid Market, the specialist will not individually handle each trade that occurs on the Exchange, and may not necessarily know of—personally or algorithmically—other trading interest available in the market prior to an execution for its proprietary account. The specialist may not, and the Specialist Algorithm will not, know whether there is floor broker reserve interest available at the BBO, or floor broker agency interest available outside the BBO. Accordingly, the specialist must make decisions whether to add orders to the specialist interest file without knowing the full extent of other trading interest available in the market, and consequently may trade on parity with other available floor broker interest.

As noted above, the Exchange believes that providing specialists parity with floor broker agency interest will incent specialists to participate in the price discovery process at the point of sale and thus dampen volatility and lower execution costs for investors. The Exchange also believes that withholding information about floor broker reserve interest at the BBO, and floor broker agency interest outside the BBO, from the Specialist Algorithm—and in some cases from the specialist himself—will allow floor brokers to more effectively represent their customer orders, and thus further incent liquidity and dampen price volatility in the Hybrid Market.

Although the Commission recognizes that these features may inhibit somewhat the ability of specialists to assess the condition of the market to comply with their ongoing negative obligations under SEC Rule 11b-1 and NYSE Rule 104, the potential benefits these features may bring to the quality of the Hybrid Market justify the risks of

<sup>373</sup> See IBAC Letters I and II, ICI Letter III and Rutherford Letters III, IV, V, VI, VII, VIII, IX, and X.

<sup>374</sup> See Rutherford Letters III, IV, V, VI, VII, VIII, IX, and X. See also IBAC Letter I.

<sup>375</sup> See, e.g., Bloomberg Letters I and II, ICI Letters I, II, and III, Rutherford Letters I, II, III, and V, SIA Letter I, STANY Letter, and Vanguard Letter.

<sup>376</sup> See, e.g., ICI Letters II and III, Rutherford Letters II and V, STANY Letter, and Vanguard Letter.

<sup>377</sup> See, e.g., 15 U.S.C. 78f(b)(5) and 15 U.S.C. 78k.

<sup>378</sup> 15 U.S.C. 78f(b)(5).

<sup>379</sup> 15 U.S.C. 78f(b)(5) and 15 U.S.C. 78k-1.

<sup>380</sup> 17 CFR 240.11b-1(a)(2). In light of these changes, the Commission expects the Exchange to update its surveillance procedures and the specialist firms to update their compliance programs to ensure that specialist trading is conducted in a manner that is consistent with the requirements of the Act and NYSE rules.

<sup>381</sup> 15 U.S.C. 78k(b).

unnecessary specialist trading. The specialist must design its Specialist Algorithm to support a fair and orderly market, which includes varying its position in light of the anticipated needs of the market. The specialist also must adjust the operation of the Specialist Algorithm to the extent it becomes aware of changes in the market that would render its operation inconsistent with its obligation. However, the Commission recognizes that the specialist may, and the Specialist Algorithm will, have less than full information about the floor broker interest. So long as the specialist has programmed the Specialist Algorithm, taking into account and including as inputs all relevant factors available to the Specialist Algorithm, in a manner designed to support a fair and orderly market, and the specialist has made adjustments to the operation of the Specialist Algorithm based on its knowledge of market information, the Commission believes the specialist could trade on parity with floor broker interest consistent with its obligations under SEC Rule 11b-1 and NYSE Rule 104 in the Hybrid Market.<sup>382</sup>

In addition, the Commission finds that NYSE's proposal to permit interest in the floor broker agency interest files to trade on parity with orders in the Book, subject to certain limitations, is consistent with the requirements of the Act. NYSE appears to have sought to balance the incentives for placing interest in the Book against the ability of floor brokers to effectively represent their customers. The proposal limits the ability of interests in the floor broker agency interest files outside the BBO to trade on parity with orders in the Book by requiring floor brokers to designate the amount of interest that would be displayed if the price becomes the Exchange BBO, and permitting only that amount to trade on parity. The Commission believes that providing floor brokers with this additional incentive to place liquidity in the Display Book system could allow them to more effectively represent their customer orders, without materially

reducing the incentives to display liquidity on the Book.

The Commission believes that exchanges have a degree of flexibility, in their judgment, to determine the methods of non-discretionary order interaction on their markets so long as the requirements of the Act are met. Accordingly, the Commission believes that NYSE's proposed changes to its rules of priority, parity and precedence are consistent with the requirements of the Act.

#### *E. Role of Specialist in the Hybrid Market*

To preserve a meaningful role for the specialist, NYSE has proposed to permit specialists to participate electronically in the Hybrid Market and replicate certain existing specialist privileges in an electronic manner. For example, NYSE has proposed to provide specialists with access to certain information about incoming orders before they are processed by the Display Book system.<sup>383</sup> This information would be transmitted to the specialist via the API. Based on this and other information, specialists would use the Specialist Algorithms to generate quoting or trading messages, which would be transmitted to the Display Book system via the API. The Specialist Algorithm would be able to make limited quoting and trading decisions in response to incoming orders, such as to provide price improvement, improve the Exchange BBO, or supply size to fill the incoming order at the Exchange BBO.

The proposal to create Specialist Algorithms generated several comments. Five commenters believed that it would be unfair for the Specialist Algorithms to view information prior to other market participants and for the specialist to act on that information.<sup>384</sup> These commenters believed that other market participants should be given the same opportunity.<sup>385</sup> For instance, one commenter viewed as one-sided NYSE's proposal to provide specialists with the ability to algorithmically trade with incoming orders while providing no similar tool for floor brokers, and believed this would thwart, rather than foster, fair competition.<sup>386</sup> Another commenter was concerned that the information barriers within a specialist firm could be breached, resulting in the dissemination of non-public

information outside the Exchange, including upstairs traders or other business units affiliated with the specialist firm.<sup>387</sup> This commenter believed that the Exchange should affirmatively state a prohibition against such sharing of information.

Specialists will continue to be required to perform their obligations to maintain a fair and orderly market.<sup>388</sup> For example, pursuant to NYSE Rule 104, specialists will continue to be required to trade for their own account when there is a lack of price continuity, depth, or a disparity between supply and demand. In addition, specialists will continue to oversee the auction market and play an active role when large transactions are routed to the NYSE floor for execution. To enable specialists to effectively perform these functions, NYSE has proposed to replicate some of the existing specialist privileges—including an informational advantage—in an electronic manner. As discussed below, the Commission finds that NYSE has sufficiently limited the specialists' informational advantage so that, in light of the specialists' ongoing duties and obligations to the market, the proposal is consistent with the requirements of the Act.

#### *1. Price Improvement*

Under the proposal, the specialist could program its algorithm to offer price improvement to incoming orders under certain circumstances. The amount of price improvement would vary, depending on the spread. For example, price improvement must be at least three cents when the spread is more than five cents, at least two cents when the spread is three cents to five cents, and one cent when the spread is two cents. To offer electronic price improvement, the specialist must be represented in the bid or offer in a meaningful amount, which NYSE would define as a minimum of 1,000 shares for the most 100 active stocks on the Exchange and 500 shares for all other stocks on the Exchange.<sup>389</sup>

Commenters objected to the ability of a specialist to provide price improvement electronically to all or part

<sup>382</sup> NYSE has represented that prior to the rollout of the third phase of the Hybrid Market, it will develop guidance to clarify how it expects specialists to comply with the NYSE Rule 104 in the Hybrid Market. Telephone call between Catherine R. Kinney, President and Co-Chief Operating Officer, NYSE Group, Inc., and Richard G. Ketchum, Chief Regulatory Officer, NYSE Regulation, Inc., and Kelly M. Riley, Assistant Director, Division, SEC, on March 22, 2006. See also Amendment No. 8. The Commission believes that specific guidance is necessary to help assure that specialists can effectively program the algorithms to trade in compliance with the negative obligation.

<sup>383</sup> See *supra* note 167.

<sup>384</sup> See IBAC Letter I, ICI Letters I, II, and III, Rutherford Letters I, III, and V, SIA Letters I and III, and Vanguard Letter. See also IBAC Letter II.

<sup>385</sup> See *id.*

<sup>386</sup> See IBAC Letters I and II. See also ICI Letter III.

<sup>387</sup> See Invictus Letter.

<sup>388</sup> See also Section IV(D), *supra*, for a discussion on the application of SEC Rule 11b-1 and NYSE Rule 104 in the Hybrid Market.

<sup>389</sup> The Exchange would determine the 100 most active stocks based on the average daily volume and would provide notice to its members on a quarterly basis, or more frequently as the Exchange from time to time shall determine. See proposed NYSE Rule 104(e)(ii).

of a marketable incoming order.<sup>390</sup> One commenter believed that the specialist's ability to provide algorithmic price improvement would not be as fair of a process as price improvement resulting from genuine order competition in the auction market which can be verified by other market participants at the point of sale.<sup>391</sup> Two commenters insisted that the Exchange supplement its proposal to grant floor brokers with a similar ability to provide electronic price improvement to orders.<sup>392</sup> Another commenter believed that if the specialist is willing to improve the NYSE BBO, the specialist should display that price in its quote.<sup>393</sup>

The Commission believes that the ability of specialists to offer price improvement to incoming orders is consistent with the requirements of the Act. The Commission notes that NYSE specialists today are permitted to provide price improvement to incoming orders in the auction market. With this proposal, NYSE is providing specialists with the ability to continue to offer price improvement in an electronic environment, but only if the specialists satisfy certain conditions. As noted above, specialists would be required to be meaningfully represented in the BBO and to provide a minimum amount of price improvement. The Commission also notes that Specialist Algorithms could only offer price improvement to incoming marketable orders; incoming orders that would improve the Exchange BBO would be quoted as the new BBO. The Commission believes that permitting specialists to algorithmically price improve marketable orders by certain minimum amounts could increase the quality of its electronic market, and that the condition that specialists be meaningfully represented in the bid or offer might enhance depth and liquidity at the NYSE BBO.

## 2. Ability To Hit Bids or Take Offers

In addition to offering price improvement to incoming marketable orders, Specialist Algorithms could also generate trading messages that would trade with the Exchange BBO. The Commission notes that NYSE has proposed to implement safeguards that prohibit the Specialist Algorithms from obtaining a time advantage over the public, by delaying the processing of algorithmic messages to trade with the Exchange BBO. The Commission believes that the capability of the

Specialist Algorithms to hit bids or take offers is designed to assure specialists are on a level playing field with other market participants with respect to their ability to interact with the Exchange BBO, and is consistent with the requirements of the Act. Further, the Commission notes that capability of the Specialist Algorithms to hit bids or take offers must be consistent with their obligations under NYSE Rule 104 and Rule 11b-1 under the Act.

## 3. NYSE Rule 92

NYSE Rule 92 reflects the fundamental tenet of agency law that an agent must place its customer's interest ahead of its own proprietary interest. In essence, Rule 92 prohibits an NYSE member from buying or selling for its own account an Exchange-listed security when it knows that it is holding a customer order that is executable at the same or better price. NYSE has proposed to clarify when the Specialist Algorithms would be deemed to have knowledge of an incoming order. Specifically, NYSE has proposed that the Specialist Algorithm would not be deemed to have knowledge of an incoming order, for purposes of Rule 92, if the Specialist Algorithm is designed and operated in a manner that prevents its handling of an incoming order from being affected by the receipt of subsequent orders in the same security. NYSE believes that this amendment is necessary because there could be situations where the Specialist Algorithms generate a quoting or trading message, and before the Display Book system can process the message, the Specialist Algorithms receive and process information about a subsequent incoming order that is at the same or better price. The Commission believes that the proposed amendment to Rule 92 is consistent with the requirements of the Act, and should maintain the same level of protection for customer orders in an electronic environment as exists today in a manual environment.

## 4. Communicating With the Specialist Algorithm

NYSE proposes to allow specialists to interact with the Specialist Algorithms through a wired or wireless device that has been registered with NYSE, such as a computer terminal or laptop, to activate or deactivate a particular algorithm or adjust its parameters. NYSE also proposes that specialist firms be required to create and maintain records of all messages generated by the firms' wired or wireless devices. The Commission believes that providing specialists with this functionality would enhance their ability to function in an

electronic environment, and is consistent with the requirements of the Act. In this regard, the Commission expects the Exchange to implement adequate surveillance procedures and to engage in ongoing monitoring of the wired and wireless devices to ensure that they are being used in a manner consistent with the NYSE's rules, and the securities laws and rules. NYSE is also requiring that specialists have an independent third party auditor review on an annual basis the Specialist Algorithms to ensure that they operate in accordance with all SEC and Exchange rules, policies, and procedures. The Commission notes that the Exchange has the responsibility under the Act to enforce compliance with the Federal securities law and NYSE rules.<sup>394</sup> The Commission expects NYSE to review any reports, notes, analysis, documents and similar types of materials from such independent auditing as part of the Exchange's surveillance procedures.

## F. Changes to the Auction Market and New Order Types

As part of the Hybrid Market, the Exchange has also proposed to modify its auction market. Specifically, the Exchange is proposing a new order type—the AL order—and changes to the way market orders (AM orders) are handled on the floor to accommodate investors who wish to have their orders exposed for price improvement. Under the proposal, AL orders and AM orders would be automatically executed when the Exchange quotation is at the minimum variation of one cent. Otherwise, these orders would be placed in the Display Book system for an opportunity to receive a better price than the Exchange BBO. If an AL order or an AM order has not been executed after 15 seconds, it would be automatically executed at the prevailing bid or offer, provided that automatic executions are available. In addition, certain events could cause an AL order or an AM order to automatically execute prior to the 15-second period.

NYSE's proposal to adopt the AL order and the AM order would offer customers the option to seek price improvement for their orders in a more rapidly-moving Hybrid Market. The Commission believes that these features could improve execution quality for those customers who do not seek an immediate execution, and generally increase the depth and liquidity of NYSE's market. The Commission

<sup>390</sup> See, e.g., IBAC Letters I and II, ICI Letter III, Rutherford Letters I, III, and V, and Vanguard Letter.

<sup>391</sup> See Rutherford Letter III.

<sup>392</sup> See IBAC Letters I and II and ICI Letter III.

<sup>393</sup> See Vanguard Letter.

<sup>394</sup> See also note and Sections 6(b)(1) of the Act, 15 U.S.C. 78f(b)(1), and 19(g)(1) of the Act, 15 U.S.C. 78s(g)(1).

believes the decision by NYSE to provide investors with the ability to place AL and AM orders is within its discretion and consistent with the requirements of the Act.

#### G. Intermarket Sweep Order

To implement the requirements of Rule 600(b)(30) of Regulation NMS,<sup>395</sup> the Exchange proposes to amend NYSE Rule 13 to adopt a new order type—an Intermarket Sweep order. As proposed, an Intermarket Sweep order would be a limit order designated for automatic execution in a particular security that meets the following requirements: (1) It is identified as an intermarket sweep in the manner prescribed by the Exchange; and (2) simultaneously with the routing of the Intermarket Sweep order to the Exchange, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bids (offers) in the case of a limit order to sell (buy), with a price that is superior to the limit price of the limit order identified as an Intermarket Sweep order. These additional routed orders must be identified as Intermarket Sweep orders. An Intermarket Sweep order would be immediately and automatically executed against the displayed bid (offer) up to its full size in accordance with and to the extent provided by NYSE Rules 1000 through 1004, and would then sweep the Display Book system, as provided in NYSE Rule 1000(d)(iii), with the portion not so executed to be immediately and automatically cancelled. The Commission believes that NYSE's proposed definition of Intermarket Sweep order is designed, among other things, to meet the requirements of Regulation NMS,<sup>396</sup> and to perfect the mechanism of a free and open market and a national market system and to protect investors and the public interest, and thus, is consistent with the requirements of the Act.

<sup>395</sup> 17 CFR 242.600(b)(30).

<sup>396</sup> An Intermarket Sweep order would allow market participants to simultaneously route orders to multiple markets at multiple price points. An Intermarket Sweep order is defined in Regulation NMS as "a limit order for an NMS stock that meets the following requirements: (i) When routed to a trading center, the limit order is identified as an intermarket sweep order; and (ii) simultaneously with the routing of the limit order identified as an intermarket sweep order, one or more additional limit orders, as necessary, are routed to execute against the full displayed size of any protected bid, in the case of a limit order to sell, or the full displayed size of any protected offer, in the case of a limit order to buy, for the NMS stock with a price that is superior to the limit price of the limit order identified as an intermarket sweep order. These additional routed orders also must be marked as intermarket sweep orders." See *id.*

#### H. Implementation Plan

NYSE proposed to implement the Hybrid Market in four stages over a period of months, to allow its members to familiarize themselves with these functionalities and to perform tests on its systems. As noted above, the Pilot implemented testing of the initial stage of the Hybrid Market on a temporary basis. The Commission believes that the staggered implementation would allow a gradual transition from the current auction market model to the Hybrid Market.<sup>397</sup> Further, the Commission believes that the implementation plan would provide NYSE the opportunity to test the changes to its systems. The Commission believes that the proposed implementation plan is consistent with the requirements of the Act. Due to the phased implementation of the Hybrid Market, NYSE represented that it will provide Information Memoranda to its members and update its online rulebook and Web site accordingly during each phase. The Commission believes that the Information Memoranda and web site updates should provide NYSE members with reasonable notice of and clarification on which rules or portions thereof will be effective during a particular implementation phase of the Hybrid Market.

#### I. Interpretive Issues

The Exchange has requested that the Commission extend its previous approval of certain interpretations of NYSE rules as they relate to automatic executions that occur with specialists pursuant to NYSE Rule 1001(a)(iv).<sup>398</sup> Specifically, pursuant to NYSE Rule 1001(a)(iv), specialists are required to take the contra side of an automatic execution against the published quotation, even if the specialist's interest was not part of such quotations. This requirement to take the contra side of certain automatic executions may be inconsistent with other NYSE rules or may lead to additional obligations by the specialist. Accordingly, NYSE requested and the Commission approved the following interpretations.

1. NYSE Rule 123A.40. The specialist would not be required to fill any stop orders elected by the execution of an Auto Ex Order at the price of the electing sale in any instance where the specialist was required by NYSE Rule 1001(a)(iv) to take the contra side of the automatic execution.

<sup>397</sup> If there is any delay in the implementation plan, the Commission expects the Exchange to consider whether additional rule changes would need to be filed with the Commission.

<sup>398</sup> See note *supra*.

2. NYSE Rule 91. Because the specialist does not accept an Auto Ex Order for execution or act as agent for such order, the transaction confirmation requirements for NYSE Rule 91 would not apply in any instance where the specialist is the contra party to an automatic execution.

3. NYSE Rule 104. NYSE Rule 104 contains the specialist's affirmative and negative obligations, and restricts the specialist's ability to purchase stock on direct plus ticks or see on direct minus ticks. The Exchange proposed that any instance in which the specialist is effecting a direct tick transaction only because he or she has been required to assume the contra side of an automatic execution pursuant to NYSE Rule 1001(a)(iv) shall be deemed a "neutral" transaction for purposes of NYSE Rule 104 and shall be deemed not a violation of the rule. According to the Exchange, it believes this interpretation was appropriate because the specialist is not setting the price, but is simply being required to trade at a price set by other market participants.

The Commission finds that these interpretations are consistent with the requirements of the Act because they would allow the specialist to provide liquidity in certain situations without triggering other rules or obligations. As noted above, the Commission previously approved these interpretations in the approval of Direct+.<sup>399</sup> The Commission believes that they should promote just and equitable principles of trade and protect investors and the public interest because they should assist in the execution of Auto Ex Orders.

#### V. Accelerated Approval of Amendment Nos. 6, 7, and 8

As set forth below, the Commission finds good cause to approve Amendment Nos. 6, 7, and 8 to the proposed rule change, as amended, prior to the thirtieth day after the amendments are published for comment in the **Federal Register** pursuant to section 19(b)(2) of the Act.

In Amendment No. 6, NYSE proposes to amend the rules that would allow specialists to provide price improvement to incoming orders. Specifically, NYSE proposed to reinstate the requirement that the specialist be represented in the bid (offer) in order to provide price improvement.<sup>400</sup> In

<sup>399</sup> See note 203 *supra*.

<sup>400</sup> In the Second Notice, NYSE proposed to require specialists to be represented in the bid (offer) by the lesser of 10,000 shares or twenty percent of the size of the market on the side which the transaction would take place. In the Third

Amendment No. 6, NYSE proposed to require specialists to be represented in the bid (offer) in a "meaningful amount," which it proposes to define as a minimum of 1,000 shares for most securities. The Commission notes that NYSE proposes to further amend this provision in Amendment No. 8, as described below. Finally, the Exchange amended Rule 104 to state that specialists may only provide price improvement to incoming orders that are marketable.

The Commission finds good cause to accelerate approval of these changes prior to the thirtieth day after publication in the **Federal Register**. The Commission finds that prohibiting specialists from providing price improvement to non-marketable orders should provide investors with more current information regarding the prices at which other investors are willing to trade.

In Amendment No. 6, NYSE also proposes to limit the ability of interest in the floor broker agency interest file to trade on parity with orders on the Book outside of the Exchange BBO. Specifically, floor brokers would be required to designate the size that it would display should a price outside of the BBO move to the BBO. The size designated for display would be permitted to trade on parity with orders on the Book during a sweep at the clean-up price. The size designated to be placed in reserve (*i.e.*, remain undisplayed) would yield to displayed interest.

The Commission finds good cause to accelerate approval of this change prior to the thirtieth day after publication in the **Federal Register** because the proposed change limits the ability of undisplayed interest to trade with displayed interest, which should enhance the execution of orders displayed on the Book, and may provide incentives to floor brokers to increase the size of interest eligible for display.

In Amendment No. 7, NYSE proposes to modify to its proposed changes to its Rule 92. Specifically, NYSE proposes to define when a specialist has knowledge for purposes of the rule in the context of the Specialist Algorithm. Specifically, a specialist would not be deemed to have knowledge of an order that is received while the Specialist Algorithm is transmitting a quoting or trading message based on the knowledge of an earlier order, if the Specialist Algorithm is designed and operated in a manner that prevents a quoting or trading

message from being affected by the knowledge of the later order.

The Commission finds good cause to accelerate approval of this change prior to the thirtieth day after publication in the **Federal Register** because it better defines the scope of knowledge for purposes of the Specialist Algorithm. The Commission believes that the change is narrowly tailored to this specific circumstance to ensure that specialists cannot trade for their own accounts when they have knowledge of an order.

In addition, NYSE proposes to amend its Rule 13.30 and the definition of stop orders to reflect that elected stop orders in the Display Book system would be eligible for automatic execution in Direct+. <sup>401</sup> This change conforms NYSE's Hybrid Market proposal to changes proposed by NYSE in an earlier filing. <sup>402</sup> Accordingly, the Commission finds good cause to accelerate approval of this change because it updates NYSE's proposal to make it consistent with previously filed rule changes. Finally, NYSE proposes to amend its rule text to correct typographical errors, reflect other rule changes that have been approved by the Commission, and further clarify its rules. For example, NYSE modified its definition of All or None Order in its Rule 13 to reflect current NYSE rule text, amended other definitions to reflect new citations to Regulation NMS, and amended NYSE Rule 60(e) to clarify that Autoquote will automatically update the NYSE BBO to reflect floor broker agency interest and specialist interest as well as non-marketable limit orders. The Commission finds good cause to accelerate approval of these changes prior to the thirtieth day after publication in the **Federal Register** because they better clarify the NYSE's rules, which should assist members' ability to comply with their requirements, and assist investors in understanding their application and scope.

Finally, in Amendment No. 8, NYSE proposes to: (1) Amend proposed NYSE Rules 13 and 124 to specify that a round lot portion of a PRL order is an Auto Ex Order and that the odd lot portion of a PRL order would be executed in the Odd Lot Execution System at the same price as the round lot portion of the PRL; (2) amend proposed NYSE Rule 13 to reflect that stop orders and stop limit orders may still be represented

manually by a floor broker in the Crowd; (3) amend the definition of IOC order in proposed NYSE Rule 13 to: (a) Propose an IOC order that is designed to be in compliance with Regulation NMS; (b) specify that NYSE IOC orders would be eligible to be routed away during a sweep; and (c) eliminate the previously proposed changes to the treatment of ITS Commitments; <sup>403</sup> (4) amend the definition of Intermarket Sweep order in proposed NYSE Rule 13 to permit such order to sweep the Display Book system and then immediately cancel any portion remaining unexecuted; (5) amend proposed NYSE Rule 36 to state that a specialist may only use a wired or wireless device that has been registered with the Exchange to communicate with the Specialist Algorithms and provide that specialist firms must create and maintain records of all messages generated by the Specialist Algorithm; (6) amend proposed NYSE Rule 60 to: (a) Set forth the instances during which Autoquote will update the quote even if automatic executions are not available; (b) set forth the instances during which Autoquote will update the quote when Autoquote and automatic execution are suspended and disseminate a 100 share quote in certain situations; and (c) propose to use an indicator when the NYSE quote is not available for automatic execution due to a gapped quotation or LRP to signify that the NYSE quote is not firm; (7) amend proposed NYSE Rule 70.20 to: (a) Permit a floor broker to leave the Crowd without canceling its floor broker agency interest file to recharge its handheld device and (b) specify the procedures for entering interest in the floor broker agency interest file before the open; (8) amend proposed NYSE Rule 72 to specify the priority and parity rules for instances when there are shares remaining after a sweep that triggers an LRP; (9) amend NYSE Rule 76 to reflect that it would not apply to elected stop or stop limit orders other than those manually represented in the Crowd by a floor broker; (10) amend proposed NYSE Rule 104 to: (a) Permit specialists to manually layer proprietary interest in the specialist interest file; (b) permit specialists to enter certain quoting messages when automatic executions and Autoquote are suspended; (c) amend the definition of "meaningful amount" for purposes of determining when a specialist could provide price improvement; and (d) require specialists to hire independent auditors to review their algorithms on an annual basis; (11) amend proposed NYSE Rule 123A.30 to: (a) Provide

<sup>401</sup> The Commission notes that NYSE proposed further changes to these rules and NYSE Rule 76 regarding stop orders in Amendment No. 8.

<sup>402</sup> See Securities Exchange Act Release No. 52362 (August 30, 2005), 70 FR 53701 (September 9, 2005).

<sup>403</sup> See also note 22 *supra*.

systematic conversion of CAP-DI orders on the same side as a specialist when the specialist is bidding (offering) or trading and an automatic execution occurs against the specialist's proprietary interest and (b) clarify the execution of contra-side elected and converted CAP-DI orders; (12) amend proposed NYSE Rule 123F to codify that NYSE may execute an AL order or AM order at a price that matches a better away market; (13) amend proposed NYSE Rule 1000 to: (a) Clarify that automatic executions will resume in the same manner as Autoquote; (b) prohibit short sale orders, except those for Regulation SHO pilot securities, from sweeping the Display Book system; (c) eliminate the provision that would have suspended the operation of Direct+ when an away market disseminates a better quote; (d) eliminate the proposal that would have permitted automatic executions to continue while the specialist reports a block trade until the quote decremented to 100 shares; (e) specify the process for determining when a high-priced security would be eligible for automatic executions; (f) specify that automatic executions would be suspended on one side of the market when a bid (offer) is outside the MLRP; (g) specify that any shares remaining after an execution in IOC orders, NYSE IOC orders, or Intermarket Sweep orders would be cancelled after sweeping the Display Book system; and (h) clarify that auto ex limit orders, except IOC orders, that are not able to be immediately executed due to a suspension of Direct+ would be placed in the Book; and (14) amend Rule 1001.

The Commission finds good cause to accelerate approval of these changes prior to the thirtieth day after publication in the **Federal Register** for the reasons discussed below. The Commission notes that many of the changes proposed in Amendment No. 8 were previously disclosed in earlier amendments and notices and the Pilot. The Exchange, in Amendment No. 8, merely proposes to codify these requirements in its rules, which the Commission believes should ensure that market participants are fully apprised on how the Hybrid Market would operate and ensure that NYSE rules are complete. Specifically, NYSE proposes the following changes, which were published in one of the three Hybrid Market notices or the Pilot.

1. NYSE proposes to amend proposed NYSE Rules 13 and 124 to reflect the execution of PRL orders, which was discussed in both the Second and Third Notices. In the Second Notice, NYSE proposed to amend NYSE Rule 124 to reflect that the round lot portion of a

PRL order would be automatically executed in Direct+. In Amendment No. 8, NYSE proposes to make a conforming change to NYSE Rule 13. In the Third Notice, NYSE represented that the odd lot portions of PRL orders would be executed in the Odd-Lot Execution System. In Amendment No. 8, NYSE proposes to reflect this language in its Rule 124 and to state that the odd lot portion of a PRL would be executed at the same price as the round lot portion.

2. NYSE proposes to amend its Rules 60(e)(iv)(a) and 1000(c) to specify that when the NYSE bid (offer) is outside the MLRP range and such MLRP has not yet been reached, automatic executions on that side of the market would not be available but Autoquote would remain active. NYSE discussed this aspect of the Hybrid Market in its Third Notice.

3. NYSE proposes to add language to its Rule 1000(b) to provide that automatic executions would resume in the same manner as Autoquote as set forth in proposed NYSE Rule 60(e). This process was discussed in the Second Notice.

4. NYSE proposes to specify in its Rule 70.20(j) that a floor broker may enter interest in its floor broker agency interest file prior to the open regardless of its location on the floor. The floor broker, however, must be in the Crowd at the open in order to participate. NYSE discussed this provision in the Third Notice.

5. NYSE proposes to amend its Rule 123F to codify that NYSE may execute an AL order or AM order at a price that matches a better away market. NYSE originally proposed this function in the Third Notice.

6. NYSE proposes to amend NYSE Rule 1000 to provide that short sale orders must comply with Commission Rule 10a-1 and Exchange Rule 440B, which would prohibit short sale orders, other than orders for those securities included in the Regulation SHO pilot, from sweeping the Display Book system. The NYSE proposed this restriction in the Second Notice.

7. Proposed NYSE Rule 13—Stop and Stop Limit Orders. In Amendment No. 8, NYSE proposes to permit floor brokers to continue to represent stop and stop limit orders in the Crowd. NYSE originally proposed this change in the Pilot. The Commission finds good cause to accelerate approval of this change because it could provide investors with an additional means to have their orders represented on NYSE and is consistent with NYSE's current rule.

8. NYSE proposes to amend its Rule 104 to allow specialists to manually place interest in the specialist interest

file to ensure that the specialist would be able to place its interest in the Display Book system if its algorithm is not operating. NYSE originally proposed this provision in the Pilot. The Commission finds good cause to accelerate approval of this change because it should ensure that specialists can continue to participate in the Hybrid Market and fulfill their obligations to maintain a fair and orderly market.

9. NYSE proposes to amend NYSE Rule 76 to provide that its requirements would not apply to elected stop or stop limit orders other than those represented in the Crowd. NYSE originally proposed this change in the Pilot. The Commission finds good cause to accelerate approval of this change because it reflects the change NYSE proposes with regard to the automatic execution of elected stop and stop limit orders in the Display Book system.

The Commission also finds good cause to accelerate approval of the other changes proposed in Amendment No. 8 for the reasons discussed below.

10. Proposed NYSE Rule 13. Definition of IOC. In Amendment No. 8, NYSE proposes to amend its definition of IOC order. As originally proposed, NYSE defined two types of IOC orders—one that would sweep the Display Book system after trading with interest at the BBO and could be routed to away markets if such away market is displaying a better price (this order would now be called a NYSE IOC order), and ITS Commitments that would only trade with interest displayed at the BBO. In Amendment No. 8, NYSE proposes to remove its proposed changes relating to ITS Commitments because its current rule needs to remain in effect in order to comply with the provisions of the ITS Plan.<sup>404</sup> NYSE also proposes to allow another type of IOC order to be entered on the Exchange for purposes of Regulation NMS. This type of IOC order would be permitted to sweep the Display Book system but would not be routed to away markets if such away market displays a price better than the NYSE BBO or sweep clean up price. In such circumstances, the IOC order (or residual if a portion is executed at the NYSE BBO) would be cancelled. The Commission finds good cause to accelerate approval of this change because it would provide investors with a means to immediately access NYSE liquidity without relying on NYSE to access away markets' liquidity, and is

<sup>404</sup> See also note 22 *supra*.

designed to be consistent with Regulation NMS.

11. Proposed NYSE Rule 13. Definition of Intermarket Sweep Order. In Amendment No. 8, NYSE proposes to amend its definition of Intermarket Sweep Order to provide that this type of order may sweep the Display Book system but would not be routed to away markets that display a better quote. In such circumstances, the Intermarket Sweep would be cancelled. The Commission finds good cause to accelerate approval of this change because it is designed to be consistent with Regulation NMS.

12. Proposed NYSE Rule 36. In Amendment No. 8, NYSE proposes to amend its Rule 36 relating to the means by which specialists on the floor can communicate with their Specialist Algorithms. NYSE had originally proposed language to amend its Rule 36 in the Third Notice. In Amendment No. 8, NYSE limits the types of communications that may be transmitted over a wired or wireless device and limits where the communications can be sent to ensure that these communications are consistent with NYSE's current telephone policy. The Commission finds good cause to accelerate approval of this change because it allows NYSE to control the ability of specialists on the floor to communicate off the floor. NYSE also proposes that specialist firms create and maintain records of all messages generated by the firms' wired or wireless devices. The Commission finds good cause to accelerate approval of this requirement because it codifies in the rules the specialist firms' recordkeeping obligations to comply with Exchange and SEC rules.

13. Proposed NYSE Rule 60. In Amendment No. 8, the NYSE proposes several changes. First, NYSE proposes to identify quotations that are disseminated when automatic executions and Autoquote are suspended by a LRP or gapped quotation as non-firm. The Commission finds good cause to accelerate approval of this change because it will provide investors with more accurate information about the state of the NYSE quotation. Next, NYSE proposes to update the quote in high-priced securities even though automatic executions are not available. First, NYSE would keep Autoquote active when an order or a cancellation of an order arrives that would not result in a locked or crossed market in a high-priced security or a manual execution takes place in such security. Second, if there is a cancellation of the Exchange best bid (offer) in a high-priced security

when the market in such security is internally locked or crossed, and autoquoting of the next best bid (offer) would create a locked or crossed market on the Exchange, NYSE would automatically generate a quote of 100 shares at the bid (offer) price that existed at the time of the cancellation. The Commission finds good cause to accelerate approval of this change because it would provide investors with additional quotation data in high-priced securities. Finally, the Exchange proposes to update its quote in the following situations even though Autoquote is suspended due to an LRP or a gapped quotation, and automatic executions are not available: (1) If part of the existing Exchange best bid (offer) cancels, the Exchange would use Autoquote to update its quote to reflect the remaining volume; (2) if the entire existing Exchange best bid (offer) cancels, the Exchange would automatically generate a quote of 100 shares at the bid (offer) price that existed at the time of the cancellation; or (3) if there is a cancellation of the Exchange best bid (offer) when the market is internally locked or crossed, and autoquoting of the next best bid (offer) would create a locked or crossed market on the Exchange, NYSE would automatically generate a quote of 100 shares at the bid (offer) price that existed at the time of the cancellation. The Commission finds good cause to accelerate approval of this change because it would provide investors with additional quotation data during the time when Autoquote and automatic executions are otherwise suspended and would alert investors that a previously disseminated quotation had been cancelled.

14. Proposed NYSE Rule 70.20. NYSE proposes to permit floor brokers to leave the Crowd for short periods of time to recharge their handheld devices. The Commission finds good cause to accelerate approval of this change because it reflects a reasonable accommodation to allow floor brokers to ensure that their equipment is operable while permitting them to continue to represent their customers.

15. Proposed NYSE Rule 72. In Amendment No. 8, NYSE proposes to specify the priority and parity of residual shares when a LRP has been triggered. The Commission finds good cause to accelerate approval of this change because it provides specificity to the execution of orders during these limited situations and is generally consistent with the Exchange's current rules.

16. Proposed NYSE Rule 104. In Amendment No. 8, NYSE proposes to

make several changes to its Rule 104. First, NYSE proposes to amend what it would consider to be a "meaningful amount" of shares that a specialist must be represented in the BBO for purposes to determining when a specialist can provide price improvement to an incoming order. Specifically, NYSE proposes to define a "meaningful amount" as at least 1,000 shares for the 100 most active securities on the Exchange, based on the average daily volume, and at least 500 shares for all other securities. NYSE would disseminate, at least quarterly, the list of the 100 most active securities. In Amendment No. 8, NYSE proposes to set the minimum number of shares for all securities rather than its previous proposal, which was not specific as to all securities. The Commission believes that having the minimums set forth in the rule for all securities should ensure that specialists can comply with the rule's requirements and ensure that all market participants are aware of the instances when a specialist would be allowed to price improve incoming marketable orders. Accordingly, the Commission finds good cause to accelerate approval of this change. Second, NYSE proposes to permit specialists to enter certain quoting messages when automatic executions and Autoquote are suspended. Specifically, specialists would be permitted to enter quotes that are outside of the Exchange's BBO, and manually enter quotes at prices that are within a previously-established locking or crossing quotation. The Commission finds good cause to accelerate approval of this change because it could enable specialists to add liquidity in preparation for the after-market and assist specialists in satisfying their obligation to make markets with appropriate depth and price continuity. Finally, NYSE proposes to require specialists to hire independent third party auditors to review their algorithms on an annual basis to ensure that the algorithms are operating in accordance with Federal securities laws and NYSE rules. The Commission finds good cause to accelerate approval of this change because it could assist specialists and the Exchange in monitoring the operation of the Specialist Algorithms.<sup>405</sup>

17. Proposed NYSE 123A.30. In Amendment No. 8, NYSE proposes to provide for the systematic conversion of marketable CAP-DI orders on the same side as a specialist when a specialist quotes or trades and an automatic execution occurs against the specialist's

<sup>405</sup> See Section IV(E)(4), *supra*.

proprietary interest. The Commission finds good cause to accelerate approval of this change because it should ensure the proper execution of CAP-DI orders when the specialist is trading. In addition, NYSE added language to its rule to specify the manner of execution of contra-side elected and converted CAP-DI orders when an automatic execution occurs against the Exchange BBO and when an Auto Ex Order sweeps the Display Book system. The Commission finds good cause to accelerate approval of this change because it clarifies in the NYSE rules how executions of contra-side CAP-DI orders occur.

18. Proposed NYSE Rule 1000. In Amendment No. 8, NYSE proposes to make several changes to its Rule 1000. First, NYSE proposes to eliminate the provision that would have suspended automatic executions when another market disseminated a better quotation. The Commission finds good cause to accelerate approval of this change because this provision was inconsistent with NYSE's proposal to immediately route orders to markets that display quotes better than NYSE's displayed quote. Second, NYSE is eliminating its proposal to allow automatic executions to continue while the specialist manually reports a block trade that involves orders on the Display Book system until the NYSE quote decremented to 100 shares. NYSE proposes to suspend automatic executions as soon as the reporting of the block transaction begins. The Commission finds good cause to accelerate approval of this change because when the specialist manually reports a block trade that involves orders on the Display Book system, the NYSE quotation is not updated to reflect new quotations, orders, or cancellations. Since the NYSE quote that is disseminated when a block trade that involves orders on the Display Book system is manually reported may not reflect the current state of the market, the Commission believes it is appropriate in that situation for the Exchange to discontinue automatic executions. Third, NYSE proposes to amend the process for determining when a high-priced security would be eligible for automatic execution. Specifically, NYSE proposes to look at the closing price of a security (or if the security did not trade during the day, then the closing bid), and if the closing price/closing bid is \$300.00 or more, then automatic executions would not be available on the next trading day on either side of the market. The Commission finds good cause to

accelerate approval of this change because it better defines the process by which NYSE would determine the availability of automatic executions for high-priced securities. Fourth, NYSE proposes to specify in its rule that any shares remaining after the execution of an IOC, NYSE IOC or Intermarket Sweep order would be cancelled. The Commission finds good cause to accelerate approval of this change because it codifies the handling of these types of orders in the NYSE rules. Fifth, NYSE proposes to amend NYSE Rule 1000 to clarify that certain Auto Ex Orders that are not able to be automatically executed due to the suspension of automatic executions would be placed on the Book. The Commission finds good cause to accelerate approval of this change because it provides specificity in NYSE rules regarding how orders would be handled.

19. Proposed NYSE Rule 1001. In Amendment No. 8, NYSE proposes to eliminate language that it had originally proposed in its Rule 1001(iv) to clarify instead in NYSE Rule 70.20(f) that the floor broker would be held to all executions involving its agency interest files, including interest that the floor broker does not cancel when leaving the Crowd. The Commission finds good cause to accelerate approval of this change because floor brokers would be responsible for executions against interest in their files and would be responsible for ensuring that their files reflect accurate information. Accordingly, there is no need for the additional language originally proposed by NYSE to Rule 1001(iv).

#### **VI. Solicitation of Comments on Amendment Nos. 6, 7, and 8**

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 6, 7, and 8, including whether such amendments are consistent with the Act. Comments may be submitted by any of the following methods:

##### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NYSE-2004-05 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission,

100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-NYSE-2004-05. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NYSE-2004-05 and should be submitted on or before April 21, 2006.

#### **VII. Conclusion**

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with sections 6(b)(5) of the Act<sup>406</sup> and 6(b)(8) of the Act.<sup>407</sup>

*It Is Therefore Ordered*, pursuant to section 19(b)(2) of the Act,<sup>408</sup> that the proposed rule change (SR-NYSE-2004-05) and Amendment Nos. 1, 2, 3, and 5 are approved, and that Amendment Nos. 6, 7, and 8 thereto are approved on an accelerated basis.

By the Commission.

**Nancy M. Morris,**

*Secretary.*

[FR Doc. 06-3012 Filed 3-30-06; 8:45 am]

**BILLING CODE 8010-01-P**

<sup>406</sup> 15 U.S.C. 78f(b)(5).

<sup>407</sup> 15 U.S.C. 78f(b)(8).

<sup>408</sup> 15 U.S.C. 78s(b)(2).