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NYSE

November 29, 2006

Nancy M. Morris, Esq.
Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, D.C. 20549-9303

Re: SR-NYSE-2006-76 ("NYSE Stabilization filing")

Dear Ms. Morris:

The New York Stock Exchange (the "Exchange" or "NYSE") is writing a supplemental response to a letter[1] submitted by one commenter in response to the Exchange's response, dated November 6, 2006, to three prior letters[2] from the same commenter in connection with the NYSE Stabilization filing.[3] This letter responds only to substantive comments on the amendments proposed in the Stabilization filing.

The Changed Competitive Environment for Specialists

In his most recent letter, the commenter simply reiterates, at length, the same arguments that he made in his prior letters on the subject filing, offering no more support for these positions than he did previously. So, for example, he continues to refer to specialists as "monopoly dealers"[4] and asserts that specialists' competitive position in 2006 is stronger than it was in 1975,[5] the last time the negative obligation was reviewed substantively.

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1 See George Rutherfurd, Consultant, dated November 14, 2006 ("Rutherfurd IV"). Hereinafter referred to as "the commenter." As none of the commenter's letters include pagination, pages references herein are based on the way in which his letters appear on the Commission website.

2 See George Rutherfurd, Consultant, dated October 11, 2006 ("Rutherfurd I"); George Rutherfurd, Consultant, dated October 20, 2006 ("Rutherfurd II"). George Rutherfurd, Consultant, dated October 26, 2006 ("Rutherfurd III").

3 See Securities Exchange Act Release No. 54504 (September 26, 2006), 71 FR 57011 (September 28, 2006) (SR-NYSE-2006-76). The Exchange submitted Amendment No. 1 to the Stabilization filing on October 25, 2006.

4 Rutherfurd IV at page 2.

5 Rutherfurd IV at page 5.

To support this argument, the commenter characterizes the profound changes in the marketplace, such as the adoption of rules mandating consolidated quote and trade reporting, firm quote and limit order display, trade through protection and the like, as merely "technological changes."[6] In reality, these changes, together with others, such as the creation of NYSE OPENBOOK® ("OpenBook") and discretionary e-Quotes and market structure changes including decimalization, internalization and the development of alternative markets, Electronic Communications Networks (ECNs) and new exchanges, have virtually eliminated the informational and trading advantages specialists possessed in the past. The specialist of 1975 was able to dominate and exert a degree of control in the pricing and trading in his specialty securities. Therefore, stabilization rules were deemed necessary to avoid the inherent conflicts that could arise as a result of his dual dealer-agent role. The specialist of 2006 no longer has such control over pricing and trading in his specialty securities and has a drastically limited agency role. These material changes more than support the proposed modifications to the NYSE stabilization rules.

In 1975, prior to the changes discussed above and our earlier letter,[7] securities trading was opaque and fragmented. NYSE stocks were traded in other venues, such as regional exchanges, but these different market centers operated in relative isolation to one another and the Exchange. There was no effective way to transmit orders among market centers; an order entered on the NYSE was executed on the NYSE. Indeed, NYSE members were prohibited from trading NYSE-listed securities in the over-the-counter markets.[8] There was no system for reporting quotations or last sales on a consolidated basis. There was no requirement that trade reports be issued on a timely basis or that limit orders be displayed immediately. There was no general dissemination of the size and prices of limit orders away from the Exchange best bid or offer. This made it extremely difficult for market participants to compare prices, a significant problem when trading occurred at twelve and one-half cent intervals. All trading on the Exchange was manual and no order could be executed without being represented by an agent – whether specialist or Floor broker. Accordingly, the Crowd was more populated and relevant to trading.

These factors resulted in a situation where the specialist had a significant informational advantage over other market participants. Only the specialist had the "big picture" – the size and price of limit orders on the "book" and the interest of brokers in his Crowd. The specialist was the first and only one with this information. All quoting and trading on the Exchange had to go through the specialist. These factors created a quote-driven market, which gave the specialist extremely broad latitude to set prices and determine the direction of the market in his stock. While brokers in the Crowd were able to trade among themselves, they offered little significant competition to the specialist. Similarly, there was little competition from other market centers.

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[6] Id. at page 6.

[7] See Letter from Mary Yeager, Assistant Secretary NYSE Group, dated November 6, 2006.

[8] See former NYSE Rule 394.

To balance the specialist's ability to dominate and control trading in his stocks, §11(b) of the Exchange Act of 1934 ("the Act") originally restricted specialist proprietary trading only to that which was reasonably necessary to permit the specialist to maintain a fair and orderly market. In 1937, the Saperstein Interpretation mandated that the reasonable necessity test be measured on a trade-by-trade basis. However, even in 1975, Congress recognized the need for a more flexible approach to specialist proprietary trading, acknowledging that competition may mitigate the need for restrictions. Accordingly, Congress deleted the negative obligation clause from the Act. In its place, Congress gave the Securities and Exchange Commission ("the Commission" or "the SEC") broad authority to define dealer obligations in response to changing conditions in the markets.

Thirty years after the change to the Act, the specialists' situation has been transformed by the remarkable evolution in the way securities trade and markets operate. Information is ubiquitous, readily available to all market participants as a result of consolidated quote and trade streams. Limit order volume and prices are disseminated via OpenBook and updated in real-time with a one second refresh rate. The expansion of NYSE Direct+® and technology available to Floor brokers has diminished the size and significance of the Crowd and enables orders entered into the Exchange system to execute at the best bid and offer without the need for human intervention. Trades now can occur at penny increments leading to less concentration of volume at wide price intervals and a reduction in average trade size. Orders are no longer captives of the market on which they were entered as a result of the order routing requirements of the National Market System rules. As a result, specialists do not have the informational advantage they once possessed. These changes have created an order-driven market that eliminates to a substantial degree the inherent conflict of interest concerns the stabilization rules were designed to address.

Another change that has significantly altered the trading landscape since 1975 is the growth of competition to the specialist. This competition comes in several forms, including increased internalization and existence of alternative execution venues and the ability of Floor brokers to compete directly with specialists to trade with orders as they enter the Exchange. In addition the creation and commoditization of smart order routing and algorithmic technologies provide customers with much greater control of their orderflow.

Increased internalization, coupled with the growth of alternative trading systems, has dramatically impacted the flow of orders and, therefore, market information available to specialists. For example, in April of 2004, internalization and other off-Exchange trading accounted for approximately 14% of the consolidated volume in NYSE-listed securities. By October 2006, that percentage had more than doubled to approximately 29%. It is likely this sort of competition will only increase as new "dark pool" entrants, such as BIDS and LeveL, and broker-dealer alliances such as Liquidnet and Lava come to market. Similarly, sell-side firms are making investments in regional exchanges (e.g., the Boston, Philadelphia and National Stock Exchanges) and ECNs/ATSs (e.g., BATS, Knight's Direct Edge and On-Trade), which will further drive competition.

The stark change in NYSE market share – from approximately 84.2% in 1976 to approximately 61.5% in October of 2006 – illustrates the effects of these changes in the competitive environment that existed thirty years ago versus that which exists today. This change in market share is particularly significant when coupled with the deep decline in specialist participation rates, which have fallen to historic lows while specialist stabilization rates have remained substantially constant. For example, the specialist participation rate for January 2002 was approximately 15.2%; by October 2006 that had fallen to just 6.3% and is even lower for Hybrid Phase III Pilot stocks, due to unfettered access to automatic executions, yet the stabilization rates during both periods was similar -- about 81.5%.

Added to the significant "off-Exchange" competition is the more effective ways Floor brokers now have to compete for trades with the specialists. Chief among these new tools are d-Quotes, which enable Floor brokers to electronically compete with specialist algorithmically-generated trading messages. Thus, a specialist message to "price improve" an incoming order will now compete for that trade with electronic instructions entered by Floor brokers governing their customers' orders. Updates to the hardware and software operating the Floor brokers' hand-held devices also enhance their ability to compete efficiently and effectively with specialists.

As a result of all of these changes, it is difficult to see how the commenter can suggest that specialists continue to have a "monopoly" over trading in NYSE-listed securities or continue to have a significant opportunity to dominate the trading or control pricing in them. The commenter's assertion that the NYSE faces less competition today than it did in 1975 is similarly meritless.

Erroneous Allegations that Specialist Algorithms Have Exclusive Access to Information and Order Flow

The commenter's letters are rife with erroneous assertions that specialists have exclusive access to information and order flow. This simply is untrue. No information is provided to the algorithm that is not also available to Floor brokers or other market participants. For example, as noted above, OpenBook provides real-time updates of limit order information. Similarly, the delays built into the current Display Book® architecture governing specialist algorithmic messages to "hit bid" or "take offer" are specifically designed to neutralize any possible informational advantage. In the same way, the commenter's assertions that specialists have exclusive opportunities to interact with order flow are mistaken. Indeed, as noted above, Floor brokers have powerful tools that enable them to fully compete electronically with specialist trading messages. Lastly, it should be noted that many markets permit certain participants unique informational or trading opportunities in certain circumstances. For example, directed order processes and passive liquidity orders, such as those available at NYSE Arca, provide Lead Market Makers, who have affirmative market-making obligations similar to those of a specialist, with unique opportunities to trade with certain order flow or in certain situations. The suggestion therefore, that NYSE specialists are being unduly favored is simply not true.

Specialists Continue to Add Value to the NYSE Market

Lastly, the commenter questions the continued need for specialists, given the changes proposed in the instant filing. Although this is nothing more than an attack on the NYSE's market structure, it is important to reiterate that the NYSE market is not wholly electronic – it is a hybrid market, encompassing both electronic and manual order execution. As such, the specialist's traditional role as a catalyst to trading continues to be significant. Moreover, certain trading situations, such as the open, close, and "breakout" situations benefit from the trade facilitation liquidity infusions provided by the specialist. Lastly, specialist involvement in trading has been shown to moderate volatility. In a NYSE study of listed company transfers from NASDAQ[9], the volatility of trading in those companies declined dramatically on the NYSE.

Clarification to Footnotes 1 and 2 of Amendment 1 to the Stabilization Filing

As a separate matter, this is to clarify that the rules noted in footnotes 1 and 2 of Amendment 1 to the Stabilization Filing, NYSE Rules 104.10(5) and 104.10(6), set forth specific requirements regarding specialist trading which are not subject to a trade-by-trade analysis. For example, NYSE Rule 104.10(5) identifies certain trades that are prohibited; as such, there is no need for an analysis of the reasonable necessity of such trades as they are always impermissible. Similarly, trades made in compliance with the re-entry requirements of NYSE Rule 104.10(6) are mandated by the rule and not subject to the trade-by-trade analysis as to their reasonable necessity.

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If you have any questions regarding the foregoing, please feel free to contact Nancy Reich, Vice President, Office of the General Counsel, at (212) 656-2475, Deanna Logan, Director, Office of the General Counsel, at (212) 656-2389.

Sincerely yours,

Mary Yeager
Assistant Secretary

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9 See Paul Bennett and Li Wei, *Market Structure, Fragmentation and Market Quality* (2003). Republished in the Journal of Financial Markets Vol. 9, No. 1, pp 49-78 (2005).