

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56017; File No. SR-NYSE-2007-21)

July 5, 2007

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Granting Approval of Proposed Rule Change as Modified by Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 3 Thereto Relating to Rule 92 (Limitations on Members' Trading Because of Customers' Orders)

I. Introduction

On February 23, 2007, the New York Stock Exchange LLC ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NYSE Rule 92, Limitations on Members' Trading Because of Customers' Orders, in order to harmonize it with similar rules of NASD and to address changes to the marketplace because of the implementation of NYSE's Hybrid Market and Regulation NMS ("Reg. NMS"). On May 22, 2007, NYSE filed Amendment No. 1 to the proposed rule change. The proposed rule change was published for comment in the Federal Register on May 31, 2007.³ The Commission received two comment letters on the proposal.⁴ On July 3, 2007, NYSE responded to the comments⁵ and, on July 5, 2007, filed Amendment No. 3 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 55804 (May 23, 2007), 72 FR 30410.

⁴ See letters to Nancy M. Morris, Secretary, Commission, from Ann Vlcek, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association ("SIFMA"), dated June 22, 2007 ("SIFMA Letter") and from Bret Engelkemier, Managing Director, Head of Equity Trading, Citigroup Global Markets Inc., dated June 21, 2007 ("CGMI Letter").

⁵ See letter to Nancy M. Morris, Secretary, Commission, from Mary Yeager, Assistant Secretary, NYSE, dated July 3, 2007 ("NYSE Response").

proposed rule change.⁶ This order approves the proposed rule change, grants accelerated approval to Amendment No. 3, and solicits comments from interested persons on Amendment No. 3.

II. Description of the Proposal

Riskless Principal Transactions

NYSE Rule 92 generally prohibits members or member organizations from trading on a proprietary basis ahead of, or along with, customer orders that are executable at the same price as the proprietary order. Currently, the rule contains several exceptions that make it permissible for a member or member organization to enter a proprietary order while representing a customer order that could be executed at the same price, so long as it is not for an account of an individual investor and the customer has provided express permission (“Rule 92(b) proprietary order”).⁷

The Exchange proposes to add a new subsection to Rule 92 that would permit riskless transactions for the purpose of facilitating the execution, on a riskless principal basis, of one or more customer orders. The proposed rule defines a riskless principal transaction as one in which a member or member organization, after having received one or more orders to buy (sell) a security, purchases (sells) the security as principal at the same price to satisfy the order(s) to buy (sell). Under the proposed rule, the member would be required to give the customer the same price it received, exclusive of any markup or markdown, commission or commission equivalent, or other fee.

⁶ The Exchange filed Amendment No. 2 on July 3, 2007 and subsequently withdrew it on July 5, 2007.

⁷ In general, these are transactions in which the member or member organization is: (1) liquidating a position held in a proprietary facilitation account and the customer’s order is for 10,000 shares or more; (2) creating a bona fide hedge; (3) modifying an existing hedge; or (4) engaging in a bona fide arbitrage or risk arbitrage transaction.

The Exchange proposes adopting the underlying order requirements of the NASD's Manning Rule⁸ for riskless principal transactions at the Exchange. Accordingly, the Exchange proposes that a riskless principal transaction can be effected on behalf of any customer order, regardless of whether from an institutional account or an individual investor. Further requirements for proposed riskless principal transactions include that the receipt time reference for the underlying order would have to be before the execution report time reference of the riskless principal transaction. Within 60 seconds of receiving an execution report from NYSE on the riskless principal transaction, members or member organizations would be required to allocate to the accounts represented in the riskless principal transaction the same price at which the order was executed on NYSE, exclusive of any markup or markdown, commission equivalent, or other fee. In addition, under the proposed amendment, firms would be permitted to aggregate only orders whose order types and instructions (including tick restrictions) permit such aggregation.

Firms would need to disclose to customers the method by which the firm would allocate the shares bought or sold in the riskless principal transaction (e.g., strict time priority, precedence based on size, etc.), and would be required to allocate shares in accordance with that method. Such method must be fair and reasonable, be consistently applied, and not unfairly discriminate against any particular class of accounts or types of orders. The Exchange would not require a specific allocation methodology, but would require that the chosen method be adequately disclosed to customers and be consistent with rules governing parity of orders.

The Exchange would require member organizations to keep certain books and records in connection with riskless principal transactions. In particular, when executing riskless

⁸ See NASD IM 2110-2 and Rule 2111.

principal transactions, firms would be required to submit order execution reports to the Exchange's Front End Systemic Capture ("FESC") database linking the execution of the riskless principal order on the Exchange to the specific underlying orders. The information that would be provided must be sufficient for both member firms and the Exchange to reconstruct in a time-sequenced manner all orders, including allocations to the underlying orders, with respect to which a member organization is claiming the riskless principal exception.

Similar to the Manning Rule, in allocating riskless principal transactions, if the riskless principal transaction includes Rule 92(b) proprietary orders, such proprietary orders must yield to orders from customers that either have not or cannot consent (for example, an individual investor with an order of less than 10,000 shares) ("non-consenting customer") and to orders from customers that have consented to trade along with Rule 92(b) proprietary orders until the non-consenting customers are filled. At that point, the Rule 92(b) proprietary order can receive an allocation along side any remaining customer orders that have consented to trade along with the Rule 92(b) proprietary order. In allocating such orders, member organizations must follow allocation methodologies that have been disclosed pursuant to proposed Rules 92(b) and 92(c)(5).⁹

Customer Consent Under Rule 92(b)

The Exchange proposes to modify the consent requirement of NYSE Rule 92(b) to eliminate the current order-by-order consent requirement and instead provide that customers may give "blanket" affirmative written consent for a member firm to trade along provided that:

- (i) the customer has received adequate prior affirmative notice of the fact that the member or member organization may trade along with its orders, including a disclosure of the method by

⁹ See Amendment No. 3.

which the member organization will allocate shares to the customer's order and a disclosure relating to the allocation methodology for riskless principal transactions that include both a Rule 92(b) proprietary order and an order from a customer that has not consented to trade along with a Rule 92(b) proprietary order; (ii) the customer affirmatively consents prior to such trading by the member or member organization; and (iii) the member or member organization's trading along is permitted under one of the exceptions contained in Rule 92.

The Exchange proposes that member organizations can document such affirmative consent either by: (i) a signed writing from the customer that acknowledges the disclosures, including that a customer can opt-out on an order-by-order basis, and provides consent; or (ii) documenting consent that was provided orally, provided that written disclosures were provided to the customer before obtaining the oral consent and the member organization provides written notice to the customer documenting that oral consent. Once a customer has provided affirmative written consent and so long as firms continue to provide written disclosures on a periodic basis, member organizations will not need to renew such affirmative consent.

The Exchange further proposes expanding the class of investors that may consent to a Rule 92(b) proprietary order. In order to harmonize Rule 92 with the Manning Rule, the Exchange proposes amending the class of investors that can consent to a member or member organization trading along with a customer order to include all institutional investors, regardless of the size of the order, and individual investors with orders of 10,000 shares or more, unless such orders are less than \$100,000 in value. To ensure consistency, the Exchange proposes to incorporate, for purposes of Rule 92 only, NASD's definition of an "institutional

account,”¹⁰ and therefore proposes adding that definition to the supplementary material to Rule 92.

Customers would retain the ability to “opt-out” on a trade-by-trade basis or to modify the instructions obtained under blanket consent, since the customer always has the option to submit an order with an instruction that the member or member organization not trade along or alter the terms for trading along with the order. The Exchange would require members and member organizations to periodically disclose this to customers as well.

Once a customer provides such “blanket” consent, a member or member organization may trade on a proprietary basis along with a customer order that is executable at the same price as a proprietary order that meets the exceptions set forth in Rule 92(b). A member or member organization may seek to include a Rule 92(b) proprietary order with a proposed Rule 92(c) riskless principal order. In such case, even though a single order is transmitted to the Exchange, the order would include both riskless and risk elements, and therefore would no longer be a pure riskless principal transaction. For purposes of parity, Exchange systems will recognize the riskless principal order as an agency order, regardless of whether the order includes any Rule 92(b) proprietary orders.

Exemption for Reg. NMS-Compliant Intermarket Sweep Orders

The Exchange proposes amending Rule 92 to add an exemption so that, when facilitating a customer order that would otherwise require the firm to either violate Rule 92 or trade through protected quotations, member organizations can comply with their Reg. NMS obligation without also violating Rule 92. Under the current rule, if a member organization is required to route intermarket sweep orders as principal to execute against the full displayed size

¹⁰ See NASD Rule 3110(c)(4).

of any protected quotation in a security (“ISO”), for example, when facilitating a customer order at a price inferior to the national best bid or offer or other protected quotations and in compliance with Rules 600(b)(30)(ii) and 611(b)(6) of Reg. NMS,¹¹ the ISO could violate Rule 92 by trading ahead of or along with open customer orders.

The proposed exemption provides that, when routing ISOs, the member organization must yield its principal executions to any open customer orders that are required to be protected by Rule 92 and capable of accepting the fill. As defined in Rule 92(a), customer orders that are required to be protected are those open customer orders that are known to the member organization before entry of the ISO. The proposed exemption would require that if a firm executes an ISO to facilitate a customer order at a price inferior to one or more protected quotations, that customer must consent to not receiving the better price obtained by the ISO(s) or the firm must yield its principal execution to that customer. In addition, the Exchange further proposes adopting the definitions of Reg. NMS in connection with the terms “protected quotation” and “intermarket sweep order.”¹²

Amendment No. 3

On July 5, 2007, the Exchange filed Amendment No. 3 to the proposed rule change. In Amendment No. 3, the Exchange amended proposed Rule 92(c)(4) to clarify that the inclusion of a Rule 92(b) proprietary order in the riskless principal transaction does not alter the allocation rights of customers that consented to trade along with a Rule 92(b) proprietary order. Therefore, when allocating a riskless principal transaction, the member firm would have to yield to all customers until any non-consenting customer orders have been filled, and only then could the member firm trade along with any remaining customer orders that have provided consent

¹¹ 17 CFR 242.600(b)(30)(ii) and 17 CFR 242.611(b)(6).

¹² See 17 CFR 242.600(b)(7) and (30).

pursuant to Rule 92(b). The Exchange also amended proposed Rule 92(d)(5) to clarify that a member firm must yield the executions of Reg. NMS-compliant ISOs to open customer orders except the customer order that the ISO was sent to facilitate, if that customer has consented to not receiving the better prices obtained by the ISO.

In addition, because it recognized that the proposed rule might require member organizations to make certain changes to their trading and order management systems, in Amendment No. 3, the Exchange proposed to delay the operative date of proposed NYSE Rule 92(c)(3), which requires member firms to provide batched end-of-day allocation reporting for riskless principal transactions, and the requirement that member firms use the riskless principal account type indicator, until January 16, 2008. Before that date, the Exchange stated that it would work with the member organizations to develop and implement the necessary changes to firms' systems and FESC to accommodate the enhanced reporting requirements contained in the proposed rule. However, the Exchange would require, as of the date that each firm implements riskless principal routing, that the member firm have in place systems and controls that allow them to easily match and tie riskless principal execution on the Exchange to the underlying orders. Finally, the Exchange recognized that the process of obtaining and documenting affirmative customer consent under the proposed amendments to Rule 92(b) will not be instantaneous, and therefore proposed that the member firms would have until September 30, 2007 to obtain documentation of affirmative consent.

III. Summary of Comments and NYSE Response

The Commission received two comments on the proposal. The commenters generally supported the proposal but expressed concern over several requirements it would impose on members and member organizations. Instead of requiring member firms to obtain affirmative

blanket consent to trade along with a customer's orders, the commenters believed that negative consent with affirmative disclosure for both institutional and individual customers would better align the Exchange's regulatory requirements with today's market conditions while also more effectively mitigating the administrative and recordkeeping burdens associated with providing customers with adequate disclosures.¹³ One commenter noted that the cost to firms to gather affirmative blanket consent likely would negate the benefit of not having to obtain order-by-order consent, as the rule requires today.¹⁴

The Exchange did not agree with the commenters that negative consent is appropriate for trading along with customer orders.¹⁵ The Exchange noted that it must strike a balance between investor protection and the imposition of unnecessary burdens on member organizations by its rules. The Exchange believed that the proposal strikes the correct balance by requiring member firms to affirmatively consent to being traded along with by member firms and relieving member firms of the administrative burdens of order-by-order consent.¹⁶ In addition, the Exchange recognized that obtaining affirmative consent is not an instantaneous process, and therefore proposed to give member firms until September 30, 2007 to obtain documentation of affirmative consent.¹⁷

The commenters expressed concern that the reporting requirements applicable to a riskless principal transaction under Rule 92 are inconsistent with NASD's riskless principal

¹³ SIFMA Letter, supra note 4, at 2; see also CGMI Letter, supra note 4, at 3.

¹⁴ SIFMA Letter at 3.

¹⁵ NYSE Response, supra note 5, at 3.

¹⁶ Id.

¹⁷ Id.; see also Amendment No. 3.

transaction reporting requirements.¹⁸ Specifically, NYSE’s rules require that a member firm mark the initial leg of a riskless principal transaction as “riskless” when the order is sent to the Exchange (“traditional approach”) as opposed to submitting an order to the Exchange marked as “principal” and a separate non-tape, non-clearing report on the second leg(s) of the facilitation transaction to the customer (“alternative approach”). The commenters noted that NASD rules provide member firms the option of taking the traditional approach or the alternative approach. The commenters believed that a large number of member firms have programmed their systems to report transactions under the alternative approach and requiring a member firm to report transactions under the traditional approach would result in significant costs to such member firms. The commenters believed that NYSE should make its rules consistent with NASD’s rules and allow member firms to use either the traditional approach or the alternative approach when reporting riskless principal transactions.¹⁹

The Exchange noted that, while the NASD has the ability to allow firms to report riskless principal transactions using the traditional approach or the alternative approach, its regulatory reporting systems are designed to use the traditional approach.²⁰ The Exchange noted that it would continue to review its trade reporting requirements for riskless principal transactions, but that, in the interim, if firms want to trade as riskless principal on the Exchange, they would be required to follow the traditional approach.²¹

¹⁸ SIFMA Letter at 3 and CGMI Letter at 2.

¹⁹ Id.

²⁰ The Exchange stated that it did not believe there to be any feasible alternative because it does not have a trade reporting facility capable of receiving riskless principal orders and because its surveillance system does not have access to NASD Order Audit Trail (“OATS”) data. NYSE Response at 4.

²¹ Id.

The commenters also expressed concern that member firms would now be required to submit order execution reports to FESC linking the execution of the riskless principal order on the Exchange to the specific underlying orders.²² The commenters requested clarification on when such reports must be submitted to FESC, suggesting that it should be end-of-day drop copy reporting, and requested that the Exchange consider possible alternatives to reporting to FESC.²³ In addition, one commenter noted its belief that the information submitted to FESC could be available to the Exchange through alternative means.²⁴

The Exchange clarified that reporting to FESC would be by end-of-day.²⁵ In addition, the Exchange proposed to delay the implementation of FESC reporting requirements for riskless principal transactions and the use of the riskless principal account type indicator until January 16, 2008 so that member organizations would have time to develop and implement the necessary systems changes to comply with such requirement.²⁶ However, the Exchange stated that if a member organization intended to execute riskless principal transactions on the Exchange before January 16, 2008, the member organization would be required to have in place systems and controls that would allow it to easily match and tie riskless principal executions on the Exchange to the underlying orders.²⁷

The commenters also noted that the proposal suggests that when allocating riskless principal transactions that include Rule 92(b) proprietary orders, orders from customers that have

²² SIFMA Letter at 3-4 and CGMI Letter at 2-3.

²³ Id.

²⁴ The commenter suggested that the Exchange could obtain such information by making a request to NASD for OTS and OATS reporting. CGMI Letter at 3.

²⁵ NYSE Response at 4.

²⁶ Id.

²⁷ Id. at 5.

consented to trade along with Rule 92(b) proprietary orders must yield to the non-consenting customer orders.²⁸ The commenters believed that the inclusion of a Rule 92(b) proprietary order in the riskless principal transaction should not alter the allocation rights of customers that consented to trade along with a Rule 92(b) proprietary order.²⁹ The commenters believed that the orders of customers who have consented to trading along should not be required to yield to the non-consenting customer orders.³⁰

The Exchange agreed with the commenters that the inclusion of a Rule 92(b) proprietary order in the riskless principal transaction should not alter the allocation rights of customers that consented to trade along with a Rule 92(b) proprietary order.³¹ The Exchange amended the proposal to ensure that no customer would be required to yield to another customer, subject to regular parity of order requirements.³²

In addition, the commenters requested that the Exchange clarify how firms should allocate fills in accordance with the proposed exemption from Rule 92 for certain Reg. NMS-compliant ISOs.³³ The Exchange clarified that a member firm must yield the executions of Reg. NMS-compliant ISOs to open customer orders except the customer order that the ISO was sent to facilitate, if that customer has consented to not receiving the better prices obtained by the ISO.³⁴

²⁸ CGMI Lette at 4 and CGMI Letter at 4.

²⁹ Id.

³⁰ Id.

³¹ NYSE Response at 5.

³² See Amendment No. 3.

³³ SIFMA Letter at 4 and CGMI Letter at 4.

³⁴ NYSE Response at 5-6.

Finally, one commenter believed that the Exchange should amend Rule 92 so that member organizations would be permitted to trade alongside of a customer order regardless of whether the specific purpose of the proprietary order is the direct liquidation or hedge of a customer facilitation position.³⁵ In its response letter, the Exchange stated that it does not believe that the instant filing is the proper vehicle for addressing the issue of expanding Rule 92(b) trading limitations, but noted that it would continue to review Rule 92 to determine whether further amendments are warranted.³⁶

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.³⁷ In particular, the Commission believes that it is consistent with Section 6(b)(5) of the Act,³⁸ which requires, among other things, that the rules of a national securities exchange be 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 Exchange proposes to add a new subsection to Rule 92 that would permit riskless transactions for the purpose of facilitating the execution, on a riskless principal basis, of one or more customer orders and proposes to adopt the underlying order requirements of the NASD's Manning Rule³⁹ for riskless principal transactions at the Exchange. Under the proposal, member

³⁵ CGMI Letter at 2.

³⁶ NYSE Response at 6.

³⁷ The Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³⁸ 15 U.S.C. 78f(b)(5).

³⁹ See NASD Rule 2111 and IM-2110-2.

firms would need to disclose to customers the method by which the firm would allocate the shares bought or sold in the riskless principal transaction, and would be required to allocate shares in accordance with that method. In addition, when executing riskless principal transactions, firms would be required to submit order execution reports to FESC linking the execution of the riskless principal order on the Exchange to the specific underlying orders, beginning January 16, 2008. The Commission believes this aspect of the proposed rule change is reasonable because it moves the NYSE's rules towards harmonization with the Manning Rule, which should eliminate duplicative and potentially conflicting regulatory obligations on member firms, while at the same time assuring that the important investor protection provisions embodied in the Manning Rule apply to Exchange transactions. The Commission believes that the Exchange's proposed January 16, 2008 implementation date for FESC reporting requirements for riskless principal transactions and the use of the riskless principal account type indicator is reasonable and should provide member organizations the necessary time to revise their systems as necessary.

The Exchange also proposes to modify the consent requirement of NYSE Rule 92(b) to eliminate the requirement that members obtain order-by-order consent from customers to permit the member to trade along with such customer, and instead provide that customers may give "blanket" affirmative written consent for a member firm to trade along, provided that certain conditions are met. In Amendment No. 3, the Exchange stated that member firms would have until September 30, 2007 to obtain documentation of affirmative consent. The Commission believes this portion of the proposal is also reasonable because it should relieve member organizations of unnecessary administrative burdens while at the same time still ensuring that Exchange members obtain meaningful customer consent to members' trading along with their

customers. The Commission also believes that the proposal to provide firms until September 30, 2007 to obtain documentation of affirmative consent is reasonable in that it should give firms flexibility to immediately make use of the new consent requirement while providing them time for implementation of the revised requirement.

The Exchange further proposes expanding the class of investors that may consent to a Rule 92(b) proprietary order to include all institutional investors, regardless of the size of the order, and individual investors with orders of 10,000 shares or more, unless such orders are less than \$100,000 in value. The Commission also believes this aspect of the proposal is reasonable because it will conform the Exchange's rule to the NASD's Manning Rule,⁴⁰ thereby eliminating potentially duplicative and conflicting obligations on member firms while assuring that such members are held to a high level of customer protection.

Finally, the Exchange proposes adding an additional exemption to Rule 92. The proposed exemption provides that when routing ISOs, the member must yield its principal executions to any open customer orders that are required to be protected by Rule 92 and capable of accepting the fill except the customer order that the ISO was sent to facilitate, if that customer has consented to not receiving the better prices obtained by the ISO. The Commission believes this change is reasonable because it will facilitate member compliance with their respective intermarket sweep order routing obligations under Rule 611 of Regulation.⁴¹

The Commission finds good cause to approve Amendment No. 3 to the proposed rule change prior to the thirtieth day after such Amendment is published for comment in the Federal Register pursuant to Section 19(b)(2) of the Act.⁴² The Commission believes that Amendment

⁴⁰ See NASD Rule 2111 and IM-2110-2.

⁴¹ 17 CFR 242.611(b)(6).

⁴² 15 U.S.C. 78s(b)(2).

No. 3 serves to clarify the proposal, raises no new issues of regulatory concern, and that publication of its provisions would needlessly delay the implementation of the proposal.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 3 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. Please include File Number SR-NYSE-2007-21 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-2007-21. 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, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00

pm. Copies of such filing also will be available for inspection and copying at the principal office of NYSE. 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-2007-21 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴³ that the proposed rule change (SR-NYSE-2007-21), as modified by Amendment No. 1, be, and hereby is, approved, and that Amendment No. 3 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴⁴

Florence E. Harmon
Deputy Secretary

⁴³ 15 U.S.C. 78s(b)(2).

⁴⁴ 17 CFR 200.30-3(a)(12).