SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-54205; File No. SR-NYSE-2005-38)

July 25, 2006

Self-Regulatory Organizations; New York Stock Exchange, Inc. (n/k/a New York Stock Exchange LLC); Order Approving Proposed Rule Change and Amendment No. 1 Thereto to Rules 104 ("Dealings by Specialists") and 123E ("Specialist Combination Review Policy") to Change the Exchange's Capital Requirements for Specialist Organizations.

I. *Introduction*

On May 26, 2005, the New York Stock Exchange, Inc. (n/k/a New York Stock Exchange LLC) (the "Exchange" or "NYSE") filed with the Securities and Exchange Commission ("SEC" or the "Commission") a proposed rule change to amend Rules 104 ("Dealings by Specialists") and 123E ("Specialist Combination Review Policy") in order to change the Exchange's capital requirements for specialist organizations pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 (the "Exchange Act")[2] and Rule 19b-4 thereunder.[3] On November 22, 2005, the NYSE amended the proposed rule change, replacing it in its entirety ("Amendment No. 1"). The proposed rule change, as amended, was issued by the Commission on December 16, 2005 and published for comment in the *Federal Register* on December 23, 2005 (the "Proposing Release").[4] In the Proposing Release, the Commission requested public comment on the proposed rule change (the comment period ended January 13, 2006). The Commission received comments from two commenters regarding the proposed rule change.[5] The NYSE responded directly to

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1 15 U.S.C. 78s(b)(1).

2 15 U.S.C. 78a et seq.

3 17 CFR 240.19b-4.

4 *See* Securities Exchange Act Release No. 52969 (Dec. 16, 2005), 70 FR 76337 (Dec. 23, 2005).

5 Mr. George Rutherfurd ("Rutherfurd"), sent three separate letters, dated January 13, 2006, March 7, 2006 and April 12, 2006. Rutherfurd's subsequent letters re-iterated the arguments made in his

the comments made by the first commenter.[6] The second commenter raised no new issues and the NYSE's responses to the first commenter addressed the comments made by the second commenter. This order approves the proposed rule change, as amended.

II. *Description of Proposed Rule Change*

Exchange Rule 104.20 ("Regular Specialists") presently requires a specialist organization to maintain sufficient financial resources to assume certain specified positions in each stock that it is allocated. Further, the rule requires specialist organizations that engage in certain types of business to maintain specified levels of net liquid assets. The rule also sets a minimum capital requirement for specialist organizations.

Exchange Rule 104.21 presently requires that specialist organizations maintain additional amounts of net liquid assets to the extent the specialist organization's market share exceeds 5% of certain "concentration measures" specified in the rule.

Exchange Rule 104.22 presently requires that, when two or more specialist organizations combine as the result of a merger, consolidation, acquisition or other combination of assets, the combined specialist entity must maintain the aggregate net liquid assets of the respective specialist entities prior to their combination. The Exchange has indicated that this is commonly referred to as the "marriage penalty." Similarly, Exchange Rule 123E(f)(i) requires that combinations of specialist organizations maintain the higher capital requirement of the combined unit, rather than allowing a possible reduction of capital.

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first letter and did not raise any additional issues. Mr. Junius Peake ("Peake"), sent one letter dated April 18, 2006.

[6] The NYSE responded to comments by letters dated February 28, 2006 and March 31, 2006.

The Exchange has proposed to amend Rules 104 and 123E to change the capital requirement of specialist organizations. The Exchange stated in the proposal that the amendments to Rule 104 are designed to more accurately address market risks and volatility. The Exchange also indicated in the proposal that the amendments to Rules 104.22 and 123E(f)(i) are intended to eliminate the "marriage penalty" capital requirement for specialist organization combinations.

The Exchange proposed that NYSE Rule 104.20 (to be re-titled "Specialist Organizations – Minimum Capital Requirements") be amended to require a specialist organization to maintain the greater of $1,000,000 or an amount calculated under the proposed amendment to Rule 104.21 described below. For ETFs, the Exchange proposed amending Rule 104.20 to clarify that a specialist organization registered solely in ETFs maintain the greater of $500,000 for each ETF or $1,000,000. These new requirements would replace the current financial requirements, which are based on the number of securities allocated to the specialist organization.

The Exchange proposed that NYSE Rule 104.21 (to be re-titled "Specialist Organizations – Additional Capital Requirements") be amended to require a specialist organization to meet, with its own net liquid assets, a minimum capital requirement determined by adding two separately calculated amounts. The first amount is equal to $1,000,000 for each one tenth of one percent (.1%) of Exchange transaction dollar volume in the specialist organization's allocated securities, plus $500,000 for each Exchange Traded Fund. The second amount – an add-on to the first amount – is calculated either by multiplying by three the average haircuts on the specialist organization's proprietary positions over the most recent twenty days, or through the use

of an Exchange-approved value-at-risk (VaR) model, which would include a multiplier of between 3.0 and 4.0 depending on the accuracy of the model (*i.e.*, the number of exceptions to its calculated VaR amount).

The Exchange also proposed amending 104.21 to require that a specialist organization's net liquid assets used to meet the proposed requirements in Rules 104.20 and .21 must be dedicated exclusively to specialist dealer activities, and must not be used for any other purpose without the express written consent of the Exchange.

The Exchange proposed that Rule 104.22 (to be re-titled "Definitions and Model Approval Process") be amended to specify certain qualitative requirements with respect to a VaR model a specialist organization uses to meet the add-on requirement in the proposed amendment to Rule 104.21. Under the proposed amendment, the VaR model would need, among other things, to: (1) be integrated into the specialist organization's internal risk management system; (2) be reviewed both periodically and annually; and (3) adequately capture specific risk. The proposed amendment also would require a specialist organization that has been granted approval by the Exchange to use a VaR model to continue to compute its net liquid asset requirement using the model, unless a change is approved upon application to the Exchange.

The Exchange proposed amending Rules 104.22 and 123E(f)(i) to eliminate certain of the requirements that arise when specialist organizations combine. The Exchange stated the increased requirements that apply after a combination would not be appropriate or necessary given the proposed amendments to Rules 104.20 and .21. However, the proposed amendments to Rule 123E(f)(i) would provide the Exchange with

discretion to temporarily revise the requirements after a specialist organization combination.

The Exchange also proposed to eliminate Rules 104.30 ("Financing of Specialists"), 104.40 ("Reports on Form SPC") and 104.50 ("Income Records"), which relate to the specialist organization financing transactions. The proposed elimination of Rule 104.30 would recognize that net liquid asset requirements must be met by assets the specialist organization holds free and clear of any liens. The elimination of Rule 104.30 would obviate the need for Rule 104.40. Finally, the recordkeeping requirements of Rule 104.50 also are no longer necessary in light of Exchange Rule 440 ("Books and Records"), which incorporates, by reference, Securities and Exchange Act Rules 17a-3 and 17a-4.

The Exchange also proposed several minor technical amendments to the rules for purposes of clarity and consistency.

III. *Summary of Comments and NYSE's Responses*

The Commission received comments from two commenters regarding the proposed rule change.[7] The Exchange responded directly to the comments made by Rutherfurd,[8] who raised six distinct issues. Peake only commented on one issue, which was substantially the same as one of the issues raised by Rutherfurd. Consequently, the Exchange's response to Rutherfurd regarding that issue served to also address Peake's comments.

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[7] *See supra*, note 5.

[8] *See supra*, note 6.

As noted previously, Rutherfurd raised six issues: 1) the Exchange should disclose in dollar amounts the anticipated impact the proposed rule amendments would have on the aggregate capitalization of specialist organizations; 2) the specialist organizations are inadequately capitalized at present; 3) the Exchange's analysis, set forth in the Proposing Release, fails to address a severely stressed market, 4) the existing specialist organization combination requirements are appropriate; 5) the proposed amendments are premature in light of the expansion of specialist organization dealer activity as a consequence of the Exchange's new "hybrid market" rules; and 6) the proposed reduced requirements would make it easier for a specialist organizations to leave the specialist business. The issue raised by Peake was substantially the same as the issue raised by Rutherfurd regarding the Exchange's new "hybrid market" rules.

A. *Material Information*

Rutherfurd stated that the Exchange failed to describe the impact of the proposed rules on specialist capitalization.[9] The Exchange responded that specialist organizations, in the aggregate, are required to maintain capital of $1.8 billion dollars, but, in fact, generally maintain capital of approximately $2.3 billion.[10] The Exchange stated that, under the proposed rules, specialist organizations would be required to maintain minimum capital of $1.1 billion, but that it is anticipated they would maintain capital in excess of the requirement.

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9 *See* Rutherfurd's January 13, 2006, March 7, 2006 and April 12, 2006 letters.

10 *See* Exchange letter dated March 31, 2006.

B. *Capitalization of the Specialist System*

Rutherfurd stated that the current capital requirements for specialist organizations are inadequate because they do not address potential market stresses or extreme events and, therefore, the proposed reduction in requirements would be inappropriate.[11] The Exchange responded that the proposed requirements establish comprehensive and prudent capitalization requirements that address the specialist system in the context of contemporary market realities, including realities attendant to severe market downturns.[12] The Exchange stated further that the proposed capitalization levels are more than adequate to buttress the specialist system when considered in conjunction with: (1) margining and financing arrangements currently available to specialist organizations; (2) the ability of specialist organizations to hedge risk; and (3) the access, in most instances, that specialist organizations have to the capital of their parent companies.

C. *VaR Models*

Rutherfurd stated that a VaR methodology is inappropriate for calculating the proposed capital requirement add-on because, while useful for day-to-day management purposes, it would not capture the potential impacts of severe market events.[13] The Exchange responded by acknowledging the limits of VaR methodologies and noting that the proposed rules require, as an initial matter, that a specialist organization maintain capital equal to $1,000,000 for 0.1% transaction dollar volume.[14] The Exchange further responded that the VaR calculated add-on is determined by multiplying the VaR amount

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11 *See* Rutherfurd's January 13, 2006, March 7, 2006 and April 12, 2006 letters.

12 *See* Exchange's February 28, 2006 and March 31, 2006 letters.

13 *See* Rutherfurd's January 13, 2006, March 7, 2006 and April 12, 2006 letters.

14 *See* Exchange letter dated February 28, 2006.

by, at least, three times. The Exchange stated that the transaction-based requirement and the VaR multiplier are designed to address extreme market events.

D. *Specialist Organization Combination Requirements*

Rutherfurd stated that the current specialist organization combination requirements are appropriate because they are intended to maintain the aggregate capitalization of the specialist organizations after a merger.[15] The Exchange responded that the current requirements arbitrarily raise capital requirements without regard for the actual risks faced by the combined entity.[16] The Exchange responded further that its proposed requirements would more closely align the capital requirements of merged specialist organizations with the amount of risk they take on and the dollar value and volatility of their portfolios.

E. *Hybrid Market*

Both commenters expressed their belief that the proposed rules are premature in light of the expansion of specialist dealer activity under the Exchange's new "Hybrid Market" rules.[17] The Exchange responded that any withdrawals of additional excess net liquid assets resulting from the proposed requirement would be gradually phased in, on a measured basis, over a nine-month period to allow for an orderly and carefully considered transition.[18] The Exchange further responded that it considered the impact of other rules, policies, procedures, and systems on the proposed rules. In addition, the

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15 *See* Rutherfurd's January 13, 2006 and March 7, 2006 letters.

16 *See* Exchange letter dated February 28, 2006.

17 *See* Rutherfurd's January 13, 2006 and March 7, 2006 letters and Peake's April 18, 2006 letter. The Exchange's Hybrid Market rules were approved by the Commission in Exchange Act Release No. 53539 (March 22, 2006).

18 *See* Exchange letter dated February 28, 2006.

Exchange responded that it would, on an ongoing basis, continue to consider the impact of the Hybrid Market rules have on the proposed rules.

F. *Specialist Organization Withdrawals*

Finally, Rutherfurd stated that the proposed rules would make it easier for existing specialist organizations to exit the specialist business.[19] The Exchange responded that it is unaware of any data to support this contention.[20] Further, the Exchange responded that the proposed rules may attract new specialist organizations.

The Commission believes that the Exchange has responded sufficiently to the issues raised by the Commenters.

IV. *Discussion and Commission Findings*

After careful review of the proposed rule changes, comments and the Exchange responses to the comments, the Commission finds that the proposed rule changes, as amended, are consistent with the requirements of the Exchange Act and the rules and regulations thereunder applicable to a national securities exchange in that they are designed to recognize contemporary approaches to managing risk and recent developments involving the structure of the Exchange.[21]

In particular, the Commission believes that the proposed rule changes are consistent with Section 6(b)(5) of the Exchange Act,[22] which requires that the rules of the exchange be designed, among other things, to remove impediments to and perfect

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19 *See* Rutherfurd's January 13, 2006 letter.

20 *See* Exchange letter dated February 28, 2006.

21 In approving this proposed rule change, the Commission notes that it has considered the proposed rule change's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

22 15 U.S.C. 78f(b)(5).

the mechanisms of a free and open market, and, in general, to protect investors and the public interest. The Commission finds that amending Exchange Rules 104 and 123E is consistent with the requirements of Section 6(b)(5) because the amendments are designed to more closely align net liquid asset requirements with a specialist organization's risks.

IV. *Conclusion*

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,[23] that the proposed rule change (File No. SR-NYSE-2005-38), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[24]

Nancy M. Morris
Secretary

[23] 15 U.S.C. 78s(b)(2).

[24] 17 CFR 200.30-3(a)(12).