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Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: SR-NYSE-2004-70 (Amendments to NYSE Rule 104.10(11) to Require that Specialists Must Yield to Later-Arriving DOT® orders)

Dear Mr. Katz:

The New York Stock Exchange (the "Exchange") is writing to respond to comments by George Rutherford, made in response to the Commission's solicitation of comments in Securities Exchange Act ("Exchange Act") Release No. 34-51048 (January 18, 2005) on the above-captioned filing. The filing proposed to amend Exchange Rule 104.10(11) to require that specialists engaged in proprietary trading must yield to later arriving marketable DOT® orders that the specialist handles if the specialist's participation has not yet been reported when the DOT® order arrives on the specialist's Display Book®.[1]

The Exchange notes as a preliminary matter that the proposed rule was crafted in response to concerns raised by the Commission's Office of Compliance Inspections and Examinations ("OCIE"), regarding specialist trading. In particular, OCIE noted to the Exchange that in situations where a specialist consummates a trade for his proprietary account, but a DOT® order enters the Display Book® before the specialist reports his proprietary trade to the tape, it appears that the specialist is improperly trading ahead of the DOT® order for his own account, even though the specialist was entitled to participate in the consummated trade. OCIE recommended that the Exchange amend its rules to require that the specialist yield to the later-arriving DOT® order, in order to avoid the appearance that the specialist is engaging in improper trading ahead.

The Rutherford comments reflect an inaccurate understanding of the proposed rule and the nature of trading on the Floor of the Exchange. As a result, we believe that the criticisms are

[1] Mr. Rutherford submitted two comment letters, on February 18, 2005 and April 8, 2005. The February 18 comment letter discusses both the above-captioned filing and SR-NYSE-2004-6 (Amending NYSE Rules 104 (Dealings by Specialists) and 123 (Record of Orders) With Respect To Certain Parity Situations), which the Commission approved on September 9, 2004. See Exchange Act Rel. No. 34-50337 (September 9, 2004). Because the latter filing has been already been approved, this letter responds only to the comments regarding SR-NYSE-2004-70.

misplaced and should be disregarded by the Commission. Nevertheless, in order to provide the Commission with useful information regarding the filing, the Exchange submits this response, which addresses the three primary objections raised by the Rutherford comment letter.

1. The practice called for in the proposed rule is properly described as "yielding" to later arriving DOT® orders.

The Rutherford letter claims that the Exchange has misused the term "yield" in describing the specialist's obligation under the proposed rule. Specifically, it suggests that the Exchange's definition defies the "traditional meaning of yielding" and will be confusing, since Section 11(a)(1)(G) of the Securities Exchange Act of 1934 (the "Exchange Act") applies the term "yield" to a situation in which the person has not yet consummated a trade ("yield priority, parity, and precedence"), while the proposed rule applies it after a specialist has already orally consummated a trade.

This is a distinction without a difference. "Yield" is defined to mean, among other things "give up possession of; relinquish" (Webster's II New Riverside Dictionary, Houghton Mifflin 1996). This general meaning of the term does not support the conclusion that yielding must precede the consummation of a trade; indeed, it implies the opposite, since one must possess something (*i.e.*, the right to trade) in order to relinquish it. Neither Section 11(a)(1)(G) nor any other provision of the Exchange Act separately defines the term "yield", and in fact, Section 11(a)(1) uses the term consistently with the general definition – and consistently with the Exchange's use of the term in the proposed rule. In each case, the specialist is giving up the right to participate in a particular trade; the only difference is when he gives up that right. Under proposed Rule 104.10(11), the giving up of the right to trade – that is, the yielding – simply occurs after oral consummation of the trade rather than before. In the circumstances, we disagree that the term "yield" is confusing or that it requires changing.

2. The proposed rule is consistent with Exchange rules governing specialist trading for the specialist dealer account.

Exchange Rules 76 and 91 require that before purchasing (selling) for his own account, a specialist must offer (bid for) the security at a price that is lower (higher), by the minimum variation, than the specialist's bid (offer) for his own account. This is to ensure that before the specialist participates in a transaction, there is no other buy (sell) interest in the market that is willing to trade at the better price. Thus, when a specialist trades for his own account, it is after determining that the specialist's price is the best available price in the market at the time the trade is consummated.

Because this procedure ensures that the specialist's bid (offer) is the best available price at the time that the dealer trade is orally consummated, any later-arriving DOT® order(s) to which the specialist must yield under proposed Rule 104.10(11) would, by definition, also be receiving the best available price in the market at the moment that that order arrived on the book. Put another way, because the specialist has just offered (bid) the security from his own account before yielding to a later-arriving DOT® sell (buy) order, he has appropriately determined that the later-arriving

DOT® order would not have received further price improvement if it were exposed to the market. This is consistent with the intent of Exchange Rules 76 and 91.

To illustrate why, consider the following two scenarios, one in which the specialist trades for the dealer account, and one in which he simply crosses two orders at the bid. For both, assume that the specialist has a buy limit order at .50 and a sell limit order at .60, which constitutes the current market. The last sale was at .49.

> Scenario 1: Specialist Trading for the Dealer Account
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> The specialist decides to sell to the bid for his own account. Consistent with Exchange rules, he orally bids for the stock at .51 but attracts no sellers. He consummates a transaction as principal at .50.
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> Scenario 2: Specialist Crossing at the Bid
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> The specialist receives a new sell limit order at .50. Prior to crossing the buy and sell orders at .50, he exposes the sell limit order to the market at .51 for possible price improvement. He finds no buyers at .51. He crosses the orders at .50.

In either of these scenarios, the proper price for the consummated transaction is .50, since the specialist has established that price as being the best available. In Scenario 1, the specialist does so by determining that there are no other willing sellers at .51; the buy limit order establishes there are no other buyers at that price. In Scenario 2, he determines that there are no buyers at .51, and therefore, there can be no argument that the sell limit order was entitled to a better price than .50.

Significantly, the subsequent arrival of a new DOT® sell order would not change the result in either scenario – even if it were instantaneously exposed for possible price improvement, the best available price at that moment is still .50. And requiring the specialist to yield to that later-arriving DOT® order under proposed Rule 104.10(11) also would not change that result, since the rule is premised on the notion that the order to which the specialist yields is marketable at the price established by the specialist for his own account. Simply put, under the proposed rule, the later-arriving DOT® order is not entitled to further price improvement since, by his actions, the specialist has already determined that the proper price for the trade (regardless of who the seller is) is .50. Thus, proposed Rule 104.10(11) is consistent with the specialist's obligations under Exchange Rules 76 and 91.

3. The proposed rule does not permit specialists to trade at the expense of later-arriving DOT® orders.

The comment letter suggests that the proposed rule would permit specialists to trade for their own accounts at the expense of the later-arriving customer order. For example, the letter assumes a transaction in which the quote is .50 bid for 1000 - .60 offered.[2] The specialist orally consummates a transaction to sell 1000 shares from his own account to the bid at .50, but before he reports the trade, he receives a DOT® order to sell at the market (the "later-arriving sell order"). He then receives a new bid for 1000 shares at a price of .55 (the "even- later-arriving buy order"). The comment letter posits that if the specialist yields to the later-arriving sell order (letting that order trade at .50) pursuant to proposed Rule 104.10(11), he is then free to sell to the even-later-arriving buy order at .55. As a result, the comment letter argues, the later-arriving sell order, which could have traded at .55, actually received an inferior price (.50), while the specialist, who intended to trade at .50, received a benefit by being able to trade at .55 instead.

But this example is based on a flawed assumption, namely that the later-arriving sell order was entitled to trade with the even-later-arriving buy order. In fact, using the sequence of events described in the comment letter, at the point that the later-arriving sell order was received into the Display Book®, the new bid has not yet been received and thus the best price in the market, established by the specialist, is .50. And, as described in section 2 above, therefore, the specialist can yield to the later-arriving sell order at .50 without violating his obligations to expose that order to price improvement. The fact that a new bid of .55 is subsequently received is irrelevant – at the time that the later-arriving sell order was received, there was a willing buyer at .50.

We recognize that as a result of the foregoing, the specialist might be able to sell to the even-later-arriving buy order at .55. While this may appear on its face unfair to the later-arriving sell order, we call to the Commission's attention two observations:

*First*, if the next sale is at .55, it is not a foregone conclusion that the specialist will be the contra party to the even-later-arriving buy order. In order for the specialist to sell at .55, it must be further assumed that there is no other sell interest in the market at that price, either before the specialist orally consummates a trade for his proprietary account, or after he agrees to trade but before he reports it to the Display Book® (in which case, he would be obligated to comply with Rule 104.10(11) a second time).[3]

*Second*, the comment letter ignores the fact that under proposed Rule 104.10(11), the specialist continues to bear the market risk of yielding to the later-arriving sell order. This may occur if, for example, after yielding to the later-arriving sell order at .50, he is unable to sell to the even-later-arriving buy order because it cancels before the specialist can trade with it. (We also note as a general matter that in this and the other examples, the comment letter utterly ignores the possibility that proposed Rule 104.10(11) could benefit the customer at the expense of specialists, since after the specialist yields to a later-arriving DOT® order, the next transaction – the one that Mr. Rutherford insists the later-arriving DOT® order should participate in – may be at an inferior price.)

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[2] We note that the Rutherford comment does not give the number of shares offered at the price proposed in the scenario.

[3] In effect, proposed Rule 104.10(11) would require the specialist to keep yielding to intervening marketable agency interest if, on successive subsequent trades, new DOT® orders entered the Display Book® before the specialist was able to report his trade for the dealer account.

We further note that if the sequence of orders is reversed – that is, if the later-arriving buy order arrives before the later-arriving sell order (a situation not addressed in the comment letter) – proposed Rule 104.10(11) would not apply. Under that sequence of orders, the intervening bid at .55 would establish a new quote that would prohibit the later-arriving sell order from trading at .50 under any circumstances, since it would constitute trading outside the newly established quote. In effect, the intervening higher bid means that the later-arriving sell order is no longer capable of trading in place of the specialist in the consummated transaction. Thus, the proposed rule would not be triggered, since the ability of the later-arriving sell order to "trade in place of the specialist in the consummated transaction" is a prerequisite for the specialist's obligation to yield. Accordingly, the specialist, consistent with his obligations under Exchange rules, could trade as principal at .50 and then cross the later-arriving buy order with the later-arriving sell order at .55.

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If you have any questions regarding the foregoing, please feel free to contact Daniel M. Labovitz, Director, Market Surveillance, at (212) 656-2081, Donald Siemer, Director, Market Surveillance, at (212) 656-6940, or Jerry Reda, Director, Market Surveillance, at (212) 656-5354.

Sincerely yours,

cc: Kimberly Allen