

Number SR-NYSE-2006-74 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-2006-74. 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 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-2006-74 and should be submitted on or before November 2, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

**Nancy M. Morris,**  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54577; File No. SR-NYSE-2006-36]

### Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Thereto To Provide Floor Brokers With the Ability To Enter Discretionary Instructions and/or Pegging Instructions With Respect to Floor Broker Agency Interest Files (e-Quotes)

October 5, 2006.

#### I. Introduction

On May 16, 2006, 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")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to provide floor brokers with the ability to enter discretionary and pegging instructions with respect to their floor broker agency interest files. On June 14, 2006 and July 11, 2006, NYSE filed Amendment Nos. 1<sup>3</sup> and 2<sup>4</sup> to the proposed rule change, respectively. The proposed rule change, as amended, was published for comment in the **Federal Register** on July 21, 2006.<sup>5</sup> The Commission received six comment letters from three commenters.<sup>6</sup> On September 13, 2006, the Exchange filed a response to the comment letters.<sup>7</sup> This order approves the proposed rule change, as amended.

#### II. Background

On March 22, 2006, the Commission approved NYSE's proposal to establish a Hybrid Market, which will alter the Exchange's market structure from a floor-based auction market with limited automated order interaction to a more

automated market with limited floor-based auction market availability.<sup>8</sup> To create its Hybrid Market, NYSE changed its rules to permit its floor members to participate in the market electronically. For example, specialists will have the ability to manually and systematically place in a separate file ("specialist interest file") within the Display Book system<sup>9</sup> their proprietary interest at prices at or outside the Exchange best bid or offer ("BBO"). In addition, specialists will establish algorithms ("Specialist Algorithm")<sup>10</sup> to send messages via an Exchange-owned application program interface to quote and trade for their proprietary accounts.<sup>11</sup>

As approved in the Hybrid Market Order, floor brokers will represent their customers' orders electronically in a separate file in the Display Book system ("floor broker agency interest file") at multiple prices at or outside the Exchange BBO ("e-Quotes"). As approved, e-Quotes can participate in automatic executions at the Exchange BBO or outside the Exchange BBO during a sweep. E-Quotes may not, however, initiate trades with incoming orders at prices better than the Exchange BBO. Accordingly, the Exchange now proposes additional changes that it believes will further replicate electronically the manner in which floor brokers represent their customers' orders on the floor. Specifically, NYSE proposes to provide floor brokers with the ability to enter discretionary instructions as to the size and/or price at which their e-Quotes may trade ("d-Quotes").<sup>12</sup> In addition, the Exchange proposes to provide floor brokers with the ability to set their e-Quotes and d-Quotes to peg to the Exchange BBO so that their e-Quotes or d-Quotes would be available for execution at the BBO as the Exchange BBO changes ("pegging").

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> In Amendment No. 1, NYSE proposed additional changes and clarifications to the proposal.

<sup>4</sup> Amendment No. 2 supersedes and replaces the original rule change and Amendment No. 1 in their entirety.

<sup>5</sup> See Securities and Exchange Act Release No. 54150 (July 14, 2006), 71 FR 41496.

<sup>6</sup> See Letters from George Rutherford, Consultant, dated June 22, 2006 ("Rutherford I"), August 3, 2006 ("Rutherford II") and September 21, 2006 ("Rutherford Letter III"); Warren Meyers, President, Independent Brokers Action Committee, dated August 11, 2006 ("IBAC Letter"); and Junius W. Peake, Monfort Distinguished Emeritus Professor of Finance, Kenneth W. Monfort College of Business, dated August 18, 2006 ("Peake Letter I") and October 3, 2006 ("Peake Letter II").

<sup>7</sup> See Letter from Mary Yeager, Secretary, NYSE, to Nancy Morris, Secretary, Commission, dated September 13, 2006 ("Response to Comments").

<sup>8</sup> See Securities and Exchange Act Release No. 53539, 71 FR 16353 (March 31, 2006) ("Hybrid Market Order").

<sup>9</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 customer limit order display book ("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 Exchange systems for the purposes of comparison, surveillance, and reporting information to customers and other market data and national market systems, *i.e.*, the Intermarket Trading System, the Consolidated Tape Association, Consolidated Quotation System, etc.

<sup>10</sup> See NYSE Rule 104(b).

<sup>11</sup> See NYSE Rule 104(e).

<sup>12</sup> NYSE also refers to d-Quotes as "discretionary e-Quotes" in its proposed rule text.

<sup>16</sup> 17 CFR 200.30-3(a)(12).

### III. Description of the Proposal

#### A. Proposed Discretionary Instructions for e-Quotes

The Exchange proposes NYSE Rule 70.25 to permit floor brokers to enter discretionary instructions with respect to the size and/or price at which the e-Quote would trade through the d-Quote functionality.<sup>13</sup> Unlike e-Quotes, d-Quotes would provide floor brokers with the means to express a price range within which they are willing to actively trade at prices at or better than the BBO. The discretionary instructions would relate to the price at which the d-Quote could trade and the number of shares to which the discretionary price instructions would apply.<sup>14</sup>

The discretionary instructions would only be active when the e-Quote is at or joins the existing Exchange BBO or would establish a new Exchange BBO.<sup>15</sup> Furthermore, discretionary instructions would be active for automatic executions only, and not active with respect to the opening or closing transactions on the Exchange.<sup>16</sup> NYSE would also apply the discretionary instructions of a d-Quote only if all the d-Quoting prerequisites are met; otherwise, the d-Quote would be handled as a regular e-Quote (notwithstanding the fact that the floor broker has designated the e-Quote as a d-Quote).<sup>17</sup> For instance, to qualify as a d-Quote, the e-Quote would be required to have a discretionary price range.<sup>18</sup> Furthermore, the floor brokers must comply with the requirements for e-Quotes, as approved in the Hybrid Market, with regard to d-Quotes, including the requirement that floor brokers be present in the Crowd when they have placed interest in their floor broker agency interest files.<sup>19</sup>

Floor brokers would be permitted to have multiple d-Quotes, with different price and size instructions, on the same side of the market. Such multiple d-Quotes would not compete with each other for execution priority; rather, the trading volume would be allocated by floor broker, not the number of d-Quotes participating in an execution.<sup>20</sup> Discretionary instructions would apply to both displayed and/or reserve

interest.<sup>21</sup> The specialist on the floor and the Specialist Algorithm would not have access to the discretionary instructions entered by floor brokers with respect to their e-Quotes.<sup>22</sup>

#### 1. Discretionary Price Instructions

NYSE proposes to provide floor brokers with the ability to set a discretionary price range within the Exchange BBO to designate the prices at which their customers are willing to trade.<sup>23</sup> The floor brokers' e-Quote must be represented in the Exchange BBO for discretionary pricing to be utilized. The price discretion set by the floor broker would be used to initiate or participate in a trade with an incoming order that is capable of trading at a price within the Exchange BBO and the discretionary price range.<sup>24</sup>

Floor brokers may also specify whether their discretionary price instructions would apply to all or only a portion of their d-Quotes. If price discretion is provided for only a portion of a d-Quote, the residual would be treated as an e-Quote.<sup>25</sup> Finally, when price discretion is used, NYSE proposes that the shares executed from the d-Quote be decremented from reserve size first, if any, and then from its displayed size.<sup>26</sup>

#### 2. Discretionary Size Instructions

In addition to discretionary price instructions, a floor broker may enter discretionary size instructions. Discretionary size instructions designate the portion of the e-Quote to which the discretionary price instructions would apply.<sup>27</sup> Floor broker may also specify a minimum and/or maximum size of contra side volume with which it would be willing to trade using price discretion.<sup>28</sup>

NYSE proposes that its systems would only consider NYSE displayed interest to determine whether the size of the contra side volume is within the d-Quote's discretionary size range. Contra

side reserve and other interest at the possible execution price would not be considered.<sup>29</sup> Interest displayed by other market centers at the price at which a d-Quote could trade would not be considered by Exchange systems when determining if the d-Quote's minimum and/or maximum size range is met, unless the Floor broker electronically designates that such away volume should be included in this determination.<sup>30</sup> Once the total amount of a floor broker's discretionary volume has been executed, the d-Quote's discretionary price instructions would become inactive, and the remainder of such d-Quote would be treated as an e-Quote.<sup>31</sup>

#### 3. Executions of d-Quotes

NYSE stated that the goal of discretionary e-Quoting is to secure the largest execution for the d-Quote, using the least amount of price discretion. Accordingly, d-Quotes may improve the execution price of incoming orders. However, if no discretion is necessary to accomplish a trade, none would be used.<sup>32</sup> In addition, future executions that could occur, such as those resulting from the execution of elected contra side CAP-DI orders, would not be considered in determining when, and to what extent, price discretion would be necessary to accomplish a trade.<sup>33</sup>

Pursuant to the proposed rules, d-Quotes would automatically execute against a contra side order that enters the Display Book system, if the order's price is within the discretionary price range, and the order's size meets any minimum or maximum size requirements that have been set for the d-Quote.<sup>34</sup> If there are multiple d-Quotes from different floor brokers on the same side of the market with the same discretionary price instructions, then such d-Quotes would trade on parity, after interest entitled to priority is executed.<sup>35</sup> Multiple d-Quotes from different floor brokers on the same side of the market also would compete for an execution, with the most aggressive price range establishing the execution price. If an incoming order remains unfilled at that price, executions within the less aggressive price range would

<sup>21</sup> See proposed NYSE Rule 70.25(a)(vii).

<sup>22</sup> See proposed NYSE Rule 70.25(a)(viii).

<sup>23</sup> See proposed NYSE Rule 70.25(b)(i).

<sup>24</sup> See proposed NYSE Rule 70.25(b)(i). The minimum price range for a d-Quote would be the minimum price variation set forth in NYSE Rule 62, currently \$0.01 for equity securities and \$0.10 for equity securities trading at a price of \$100,000 or greater. See proposed NYSE Rule 70.25(b)(ii) and NYSE Rules 62.10 and 62.20.

<sup>25</sup> See proposed NYSE Rule 70.25(b)(iii).

<sup>26</sup> See proposed NYSE Rule 70.25(b)(iv).

<sup>27</sup> See proposed NYSE Rule 70.25(c)(i).

<sup>28</sup> See proposed NYSE Rule 70.25(c)(ii).

According to the Exchange, this should allow for more specific order management by preventing the d-Quote from trading with opposite side interest that the floor broker has judged to be too little or too great in the context of the order or orders it is managing.

<sup>29</sup> See proposed NYSE Rule 70.25(c)(iii).

However, an increase or reduction in the size associated with a particular price that brings the contra side volume within a d-Quote's minimum/maximum discretionary size parameter would trigger an execution of that d-Quote. See proposed NYSE Rule 70.25(c)(v).

<sup>30</sup> See proposed NYSE Rule 70.25(c)(iv).

<sup>31</sup> See proposed NYSE Rule 70.25(c)(vi).

<sup>32</sup> See proposed NYSE Rule 70.25(d)(i).

<sup>33</sup> See proposed NYSE Rule 70.25(d)(i)(A).

<sup>34</sup> See proposed NYSE Rule 70.25(d)(ii).

<sup>35</sup> See proposed NYSE Rule 70.25(d)(iii).

<sup>13</sup> See proposed NYSE Rule 70.25(a)(i).

<sup>14</sup> See proposed NYSE Rule 70.25(a)(i).

<sup>15</sup> See proposed NYSE Rule 70.25(a)(ii).

<sup>16</sup> See proposed NYSE Rule 70.25(a)(iii).

<sup>17</sup> See proposed NYSE Rule 70.25(a)(iv). For example, if the d-Quote is not at the Exchange BBO, it would not exercise its discretionary instructions and accordingly, would function like an e-Quote instead.

<sup>18</sup> See proposed NYSE Rule 70.25(a)(iv).

<sup>19</sup> See proposed NYSE Rule 70.25(a)(v).

<sup>20</sup> See proposed NYSE Rule 70.25(a)(vi).

then occur.<sup>36</sup> In addition, d-Quotes would compete with same-side specialist algorithmic trading messages that seek to trade with incoming orders.<sup>37</sup> If the price of d-Quotes and specialist trading messages are the same, d-Quotes and the specialist messages would trade on parity.<sup>38</sup>

D-Quotes from floor brokers on the opposite sides of the market could trade with each other. In these circumstances, the d-Quote that arrived at the Display Book system last would use the most discretion necessary to effect a trade.<sup>39</sup> All executions involving d-Quotes must comply with Rule 611 under Regulation NMS ("Reg. NMS").<sup>40</sup> Accordingly, when a protected bid or offer, as defined in Reg. NMS,<sup>41</sup> is published by another market center at a price that is better than the price at which contra side d-Quotes could trade, the amount of discretion necessary to permit a trade on the Exchange that is consistent with Rule 611 would be used, or such portion of the d-Quote as is necessary would be automatically routed in accordance with Rule 611 in order to permit a trade to occur on the Exchange.<sup>42</sup>

D-Quotes also could provide price improvement to, and trade with, an incoming contra side specialist algorithmic trading message to "hit bid/take offer," just as they could with any other marketable incoming interest.<sup>43</sup> D-Quotes may initiate sweeps in accordance with and to the extent provided by NYSE Rules 1000–1004, but only to the extent of their price and volume discretion. They also could participate in sweeps initiated by other orders, but, in such cases, their discretionary instructions would not be active.<sup>44</sup> Finally, d-Quotes would not trade at a price that would trigger a liquidity replenishment point ("LRP"), as defined in NYSE Rule 1000.<sup>45</sup> Accordingly, a sweep involving a d-

Quote would always stop at least one cent before an LRP is reached.<sup>46</sup>

### B. Pegging

NYSE proposes to allow its floor brokers to enter instructions with regard to their e-Quotes so that they would "peg" the Exchange BBO. A pegging instruction may be added as a separate type of discretionary instruction and may be active along with discretionary price instructions. Specifically, under the proposed rules, a floor broker could set an e-Quote, other than a tick-sensitive e-Quote, to be available for execution at the Exchange best bid (for an e-Quote that represents a buy order) or at the Exchange best offer (for an e-Quote that represents a sell order) as the Exchange BBO changes, so long as the Exchange BBO is at or within the e-Quote's limit price.<sup>47</sup> A floor broker could similarly employ pegging for its d-Quotes.<sup>48</sup>

The Exchange proposes that pegging be active only when auto-quoting is active.<sup>49</sup> Pegging interest would trade on parity with other interest at the BBO after the interest entitled to priority has been executed. Pegging is reactive. Accordingly, a pegging e-Quote or d-Quote would not establish the Exchange BBO as result of pegging,<sup>50</sup> and therefore could not establish price priority by pegging. The existence of pegging instructions, however, would not preclude an e-Quote or d-Quote from having priority.<sup>51</sup>

E-Quotes and d-Quotes with pegging instructions will only peg other non-pegging interest.<sup>52</sup> Further, an e-Quote or d-Quote would not be able to sustain the Exchange BBO as a result of pegging, if there is no other non-pegged interest at that price, and such price is not the e-Quote's or d-Quote's limit price.<sup>53</sup> Specifically, if the lowest quotable price established by the floor broker for a pegging e-Quote or d-Quote to buy is the Exchange best bid, and all other interest at that price cancels or is executed, the pegging e-Quote or d-Quote would remain displayed at that best bid price.<sup>54</sup> Similarly, if the highest quotable price established by the floor

broker for a pegging e-Quote or d-Quote to sell is the Exchange best offer and all other interest at that price cancels or is executed, the pegging e-Quote or d-Quote would remain displayed at that best offer price.<sup>55</sup>

Floor brokers may establish price ranges for an e-Quote or d-Quote, beyond which the pegging function would not be available. Specifically, the floor broker can set a "quote price," which would be the lowest price to which a buy e-Quote or d-Quote could peg or the highest price to which a sell e-Quote or d-Quote could peg.<sup>56</sup> The floor broker may also set a "ceiling price," which is the highest price to which a buy side e-Quote or d-Quote could peg<sup>57</sup> and a "floor price," which is the lowest price to which a sell side e-Quote or d-Quote could peg.<sup>58</sup> The quote, ceiling, and floor price may be at a price other than the limit price of the order being e-Quoted or d-Quoted, but may not be inconsistent with the order's limit.<sup>59</sup>

Under the proposed rules, as long as the Exchange best bid (offer) is at or within the pegging price range selected by the floor broker with respect to a buy-side (sell-side) e-Quote or d-Quote, the pegging e-Quote or d-Quote would join such best bid (offer) as it is auto quoted.<sup>60</sup> If the floor broker does not designate a pegging range, but has instructed that its e-Quote or d-Quote should peg, the e-Quote or d-Quote would peg to the Exchange best bid (offer) as long as such bid (offer) is within the limit of the order that is being e-Quoted or d-Quoted.<sup>61</sup>

Furthermore, as an e-Quote or d-Quote pegs, its discretionary price range, if any, would move along with it, subject to any floor or ceiling price set by the floor broker.<sup>62</sup> In addition, if the Exchange best bid is higher than the ceiling price of a pegging buy-side e-Quote or d-Quote, the e-Quote or d-Quote would remain at its quote price or the highest price at which there is other interest within its pegging price range, whichever is higher (consistent with the limit price of the order underlying the e-Quote or d-Quote).<sup>63</sup> Similarly, if the Exchange best offer is lower than the floor price of a pegging sell-side e-Quote or d-Quote, the e-Quote or d-Quote would remain at its

<sup>36</sup> See proposed NYSE Rule 70.25(d)(iv).

<sup>37</sup> See NYSE Rule 104(b). Specialists are limited in the instances in which they may trade with incoming orders.

<sup>38</sup> See proposed NYSE Rules 70.25(d)(v) and 104(c)(ix).

<sup>39</sup> See proposed NYSE Rule 70.25(d)(vi).

<sup>40</sup> See Rule 611 of Reg. NMS, 17 CFR 242.611 and proposed NYSE Rule 70.25(d)(vii).

<sup>41</sup> See Rule 600(b)(57) of Reg. NMS, 17 CFR 242.600(b)(57).

<sup>42</sup> See proposed NYSE Rule 70.25(d)(vi)(A).

<sup>43</sup> See proposed NYSE Rule 70.25(d)(viii).

<sup>44</sup> See proposed NYSE Rule 70.25(d)(ix).

<sup>45</sup> LRPs are pre-determined price points that would halt automatic executions for varying periods depending on the price and remaining size, if any, of an automatic execution order. See NYSE Rule 1000. The Commission notes that NYSE has proposed to amend its LRPs. See Securities Exchange Act Release No. 54520 (September 27, 2006), 71 FR 57590 (September 29, 2006).

<sup>46</sup> See proposed NYSE Rule 70.25(d)(ix)(A).

<sup>47</sup> See proposed NYSE Rule 70.26(i).

<sup>48</sup> See proposed NYSE Rule 70.26(ii).

<sup>49</sup> See proposed NYSE Rule 70.26(iii). The Exchange represented that this means when the Autoquote System is active. Telephone conversation between Nancy Reich, Vice President, Office of the General Counsel, NYSE, and Kelly Riley, Assistant Director, Division of Market Regulation, Commission, on October 4, 2006.

<sup>50</sup> See proposed NYSE Rule 70.26(v).

<sup>51</sup> See proposed NYSE Rule 70.26(vi).

<sup>52</sup> See proposed NYSE Rule 70.26(vii).

<sup>53</sup> See proposed NYSE Rule 70.26(viii).

<sup>54</sup> See proposed NYSE Rule 70.26(viii)(A).

<sup>55</sup> See proposed NYSE Rule 70.26(viii)(B).

<sup>56</sup> See proposed NYSE Rule 70.26(ix)(A).

<sup>57</sup> See proposed NYSE Rule 70.26(ix)(B).

<sup>58</sup> See proposed NYSE Rule 70.26(ix)(C).

<sup>59</sup> See proposed NYSE Rule 70.26(ix)(D).

<sup>60</sup> See proposed NYSE Rule 70.26(x). See also note 49, *supra*.

<sup>61</sup> See proposed NYSE Rule 70.26(xi).

<sup>62</sup> See proposed NYSE Rule 70.26(xii).

<sup>63</sup> See proposed NYSE Rule 70.26(xii)(A).

quote price or the lowest price at which there is other interest within its pegging price range, whichever is lower (consistent with the limit price of the order underlying the e-Quote or d-Quote).<sup>64</sup> However, if the Exchange BBO returns to a price within the pegging price range selected by the floor broker, the e-Quote or d-Quote would once again peg to the Exchange BBO.<sup>65</sup>

Finally, a floor broker may specify the minimum and/or maximum size of same side volume to which its e-Quote or d-Quote would peg.<sup>66</sup> Other pegging e-Quote or d-Quote volume would not be considered in determining whether the volume parameters set by the floor broker have been met.<sup>67</sup>

### C. Other Proposed Changes

#### 1. NYSE Rule 70.20

The Exchange also proposes to amend NYSE Rule 70.20(j)(i) to specify that e-Quotes could participate in the closing trade, in accordance with the policies and procedures of the Exchange and NYSE Rule 70.20(k) to specify that during the close, a floor broker's reserve interest, if any, would be added to the size of its e-Quoted interest.

#### 2. NYSE Rule 123(e)

The Exchange proposes to add certain required terms regarding e-Quotes, d-Quotes, and pegging instructions as part of its Rule 123, which requires the entry of certain order information into the Exchange's Front End Systemic Capture System before such order can be represented.

#### 3. NYSE Rule 1000(d)

The Exchange proposes to amend NYSE Rule 1000(d)(iii)(A) to specify that d-Quotes will participate in sweeps in the manner specified in proposed NYSE Rule 70.25(d)(ix).

### D. Implementation

As explained in the Response to Comments, NYSE proposes to implement the proposal in Phases 3 and 4 of the Hybrid Market in two parts.<sup>68</sup> The first part, which would be implemented as part of Phase 3 of the Hybrid Market, would provide the pegging and d-Quote functionality with respect to the ability to trade with marketable orders. The second part, which would provide the d-Quote functionality with opposite-side interest anywhere in its discretionary range, is scheduled for implementation in Phase

4 of the Hybrid Market. Phase 3 is currently scheduled to commence on or about October 6, 2006 and is expected to be completed in early-December 2006. Phase 4 is expected to begin in December 2006, immediately following the completion of Phase 3.

### IV. Summary of Comments

The Commission received a total of six comment letters from three commenters on the proposed rule change<sup>69</sup> and NYSE filed the Response to Comments.<sup>70</sup> One commenter generally supported NYSE's proposal.<sup>71</sup> The other two commenters did not support the proposal and raised specific concerns about the proposal.

One commenter argued that the proposal raises significant market structure issues because he believes that it will allow hidden orders to compete directly with transparent market interest.<sup>72</sup> This commenter argues that the proposal would allow hidden order trading,<sup>73</sup> which makes the markets less transparent to those who seek liquidity and denies executions to those who post liquidity. Further, the commenter argued that hidden order trading would render meaningless the notion of published quotes or the national best bid/offer ("NBBO") because of the existence of hidden immediately executable market interest available between the published quote. The commenter believes that these results are inconsistent with the principles of Section 11A of the Act<sup>74</sup> and the Commission's Reg. NMS in that they compromise the notion that a fully transparent market is the fairest for all investors.<sup>75</sup> This commenter also argued that the d-Quote proposal would hinder the price discovery process. By hiding interest willing to trade at a specified price, investors will not be able to make fully informed pricing decisions for their orders.

The commenter disagreed with NYSE's representation that the proposal replicated the manner in which floor brokers act on behalf of their customers

in the physical auction market.<sup>76</sup> The commenter acknowledged that floor brokers have always provided in-between-the-published-quote executions on the floor but that in the physical auction, the decision of the floor broker to participate in an execution is made on a trade-by-trade basis after contra side orders arrive in the crowd. The commenter argued that in the auction "everything is transparent."<sup>77</sup> While floor brokers may hold discretionary orders that are not known to the public, these orders are not active until the floor broker makes a public bid (offer) that is known to all in the trading crowd. After a floor broker makes its bid (offer) public in the crowd, other brokers or the specialist can compete by bidding higher (offering lower). Thus, the commenter argued, "everything is transparent, as the previously 'hidden' discretionary order must be disclosed prior to the trade, and even after it is disclosed, is not guaranteed an opportunity to trade if competing market participants then bid higher (offer lower)."<sup>78</sup>

According to the commenter, the d-Quote, however, would allow floor brokers to enter into an automated system better prices that are always available for immediate execution and because they are not disclosed, other market participants are not able to compete with them to provide an even better priced execution. The commenter argues that the proposal gives floor brokers a time/place advantage because they can react to what is placed in the Book. The commenter believes that this time/place advantage is more troubling than what floor members on the Exchange currently possess because it is not mitigated by transparency at the point of sale like it is in the current auction market.<sup>79</sup> Finally, the commenter noted investors do not enjoy the same informational benefit of knowing the prices at which floor brokers' customers are willing to trade. If they did, the commenter argued, they would be able to make the decision of how to price their own orders and thus, would be able to compete with the floor brokers' customers.

The commenter also argues that the proposal was inconsistent with Sections 6(b)(5)<sup>80</sup> and 11A<sup>81</sup> of the Act.<sup>82</sup> The commenter argues that by giving floor brokers the exclusive ability to enter

<sup>64</sup> See Rutherford Letters I and III.

<sup>65</sup> See Rutherford Letter III.

<sup>66</sup> *Id.*

<sup>67</sup> See Rutherford Letters I and III.

<sup>68</sup> 15 U.S.C. 78f(b)(5).

<sup>69</sup> 15 U.S.C. 78k-1.

<sup>70</sup> See Rutherford Letters I, II and III.

<sup>64</sup> See proposed NYSE Rule 70.26(xii)(B).

<sup>65</sup> See proposed NYSE Rule 70.26(xii)(C).

<sup>66</sup> See proposed NYSE Rule 70.26(xiii).

<sup>67</sup> See proposed NYSE Rule 70.26(xiii).

<sup>68</sup> See Response to Comments.

<sup>69</sup> See *supra* note 6.

<sup>70</sup> See *supra* note 7.

<sup>71</sup> See IBAC Letter.

<sup>72</sup> See Rutherford Letter I.

<sup>73</sup> The commenter disagrees with the NYSE's classification of d-Quotes as discretionary order instructions. The commenter argues that d-Quotes are actually conditional limit orders that will be automatically and immediately executed upon the satisfaction of the specified terms entered by the floor broker. See also Peake Letters I and II.

<sup>74</sup> 15 U.S.C. 78k-1.

<sup>75</sup> This commenter urges the Commission to issue a concept release on hidden order trading to consider the implications on market transparency, published quotations, public limit order protection, and price discovery processes. See Rutherford Letter I.

discretionary instructions, the NYSE proposal is inconsistent with Section 6(b)(5) of the Act, which states that an exchange's rules cannot be designed to "permit unfair discrimination between customers, issuers, brokers or dealers \* \* \*"<sup>83</sup> In addition, the commenter argues that by requiring members to use floor brokers to enter discretionary instructions, the proposal is inconsistent with Section 11A(a)(1)(C)(i) of the Act,<sup>84</sup> which reflects Congress' belief that it is in the public interest and appropriate for the protection of investors and the maintenance of a fair and orderly market to assure the "economically efficient execution of securities transactions." This commenter argued that NYSE's proposal is a "direct impediment to economically efficient execution of securities transactions" because upstairs members can, and should be permitted to, exercise their own judgment and put discretionary instructions on their own orders without having to incur the significant additional expense of using a floor broker. This commenter believes that floor brokers will merely perform a clerical function of inputting an order with specific conditions and that the NYSE systems will thereafter represent and execute the order.

The commenter disagreed with NYSE's representation that the proposal would give floor brokers a means to compete with specialists' algorithmic trading and quoting. The commenter believes that specialist algorithmic trading on parity with interest represented by floor brokers is inconsistent with Section 11A of the Act<sup>85</sup> and argues the floor broker d-Quotes do not rectify this problem with specialist trading in the Hybrid Market. Specifically, the commenter cites Section 11A(a)(1)(C)(v) of the Act,<sup>86</sup> which reflects Congress' belief that investors' orders should have the opportunity to be executed without the participation of a dealer.<sup>87</sup>

Another commenter argued that floor brokers should continue to be allowed to object to specialists' trading on parity when opening or increasing a position,

<sup>83</sup> The commenter also argues that the proposal is anticompetitive because it benefits one class of market participants (floor brokers) at the expense of other market participants. See Rutherford Letter III. See also Peake Letter II. Another commenter argues that all market participants should have access to the "national market system." See Peake Letter I.

<sup>84</sup> 15 U.S.C. 78k-1(a)(1)(C)(i).

<sup>85</sup> 15 U.S.C. 78k-1.

<sup>86</sup> 15 U.S.C. 78k-1(a)(1)(C)(v).

<sup>87</sup> See Rutherford Letter I. See also Peake Letter II. The commenter also argues that specialists trading on parity with investors' orders represented by floor brokers is inconsistent with the specialists' negative obligation. See Rutherford Letter I.

in order to closely replicate the present auction market.<sup>88</sup> Finally, this commenter urged that d-Quotes and specialist algorithms be phased-in together.

#### *NYSE's Response*

NYSE believes that its proposal does replicate the manner in which floor brokers represent customer orders in the current auction market. Specifically, NYSE believes that d-Quotes are necessary to ensure that floor brokers are able to perform a function similar to that which they perform today as the markets become faster and more automated. NYSE believes that the proposal should allow floor brokers to electronically replicate the order management decisions they make regarding the representation of customer orders. According to NYSE, investors that use floor brokers would not be able to access the market in the manner they do today. NYSE argues that the proposed discretionary instructions and pegging ability will allow floor brokers to use their judgment and expertise in managing their customers' orders in a faster, automated market.

In response to the comment that d-Quotes would negatively impact price discovery and provide informational advantages to floor brokers, NYSE noted that d-Quote function is similar to proposals by other markets that permit non-displayed orders that trade between the quote.<sup>89</sup> Furthermore, NYSE believes that d-Quotes would replicate that which occurs in the manual auction market and would not provide more or less information than is currently available in the Exchange's market. According to NYSE, the d-Quote is "as transparent as any other floor broker-represented order that is not fully displayed in accordance with long established trading practices, SEC rules and regulations and NYSE rules and regulations." Because the Hybrid Market would continue to involve the interaction of floor brokers representing their customer's orders, limit orders on the Display Book system, and the specialist's dealer interest, NYSE believes that the price discovery

mechanism would continue to exist. NYSE argues that d-Quotes would "merely enhance the ability of floor brokers to effectively represent their customers' orders in the automated portion of the Hybrid Market" and they do not replace order interaction or the price discovery process.<sup>90</sup>

In response to the commenter's suggestion that d-Quotes would create price uncertainty, NYSE also believes that d-Quotes would provide investors with a better opportunity for price improvement and would moderate volatility by providing liquidity and better price continuity.<sup>91</sup> NYSE believes that d-Quotes would attract liquidity from incoming orders seeking the opportunity for a better priced and/or larger sized transaction that could result from an increase in competition between specialists and other floor brokers' d-Quotes.<sup>92</sup>

With respect to the concern that d-Quotes would create an "unequal informational playing field," NYSE noted while investors that use floor brokers would gain the benefits of d-Quotes, the d-Quotes do not create an unequal or unfair advantage for any market participant. NYSE pointed out that specialists and their algorithms would not know about any discretionary instructions, and floor brokers would have access only to information about their own agency interest, not to other broker's files.<sup>93</sup> NYSE refuted one commenter's suggestion that limit orders on the Book would have access to less information as a result of d-Quotes by representing that investors entering limit orders would be privy to the same information as is currently available to them, which, NYSE points out, does not presently include knowledge of a floor broker's decisions

<sup>90</sup> But see Rutherford Letter III. Disagreeing with NYSE's response, this commenter argued that floor broker and specialist interest could not promote price discovery when such interest is entirely hidden.

<sup>91</sup> See Response to Comments. But see Rutherford Letter III. This commenter objected to NYSE's position that d-Quotes would provide increased opportunities for price improvement, arguing instead that the e/d-Quote "overhangs" the market and is pre-programmed to trade automatically. The commenter claims, therefore, that the e/d-Quote is, in actuality, the "real", non-discretionary NYSE market that is willing to trade at such hidden price. Rather than receiving price improvement, the incoming order is merely receiving an execution at the real, pre-existing NYSE price.

<sup>92</sup> But see Rutherford Letter III (arguing that e/d-Quotes could not attract liquidity or enhance competition when they are hidden).

<sup>93</sup> NYSE also indicated that neither the specialist on the floor nor the specialist algorithmic trading system would have access to any of the discretionary instructions entered by the floor broker in connection with the d-Quotes. See Response to Comments.

<sup>88</sup> See IBAC Letter. See also Rutherford Letter III (stating that if the specialist is permitted to trade on parity, the Commission should demand that NYSE allow a floor broker objection mechanism in the Hybrid Market so that floor brokers could protect the public).

<sup>89</sup> NYSE believes that these types of orders were approved in response to market participants' preference for order and customer anonymity, despite the typical argument that such anonymity could be detrimental to other market participants. See Response to Comments. But see Rutherford Letter III (arguing that NYSE is not replicating hidden order (reserve) trading that is conducted in other markets).

regarding order management, until after such decisions are affected.

With respect to the commenters' implication that d-Quotes would disadvantage limit orders on the Book by denying executions to those who post liquidity, NYSE responded that the principles of priority and parity at the NYSE BBO would not be changed with the introduction of the d-Quote.<sup>94</sup> Accordingly, a limit order with priority at the BBO on the same side of the d-Quote would trade first in any execution at the quote. Furthermore, NYSE stated that d-Quotes would not force nor cause limit orders to accept different or worse prices than what their limits dictate. NYSE explained that because discretionary pricing would allow d-Quotes to trade at prices in between the quote where there are no public limit orders, d-Quotes would provide price improvement to an incoming order capable of trading at such better price and would not negatively impact the limit order displayed at a worse price. If the commenter was implying that the person entering the limit order would have entered his or her limit order at the better price had he or she known there were other market participants interested in trading at such price, NYSE responded that nothing prevented the limit order from being entered at such better price at the outset.<sup>95</sup> Furthermore, NYSE believes that nothing in the securities laws or Exchange rules require that every market participant fully disclose their interest at the best price possible; instead, customers are permitted to choose from a variety of options, including the order management provided by floor brokers.

In response to commenters' suggestion that floor brokers should retain the right to exclude specialists from trading on parity when increasing a position with respect to automatic executions, NYSE noted that this provision was approved in the Hybrid Market Order. To the extent that floor brokers wish to prevent specialists from trading on parity with their orders in the Hybrid Market, NYSE stated that floor brokers could send those orders for execution through SuperDot.<sup>96</sup> In

response to a commenter's objection to NYSE's proposal to deactivate the discretionary instructions of a d-Quote during a sweep that is initiated by other orders,<sup>97</sup> NYSE stated that this amendment recognizes that when a d-Quote is participating in a sweep, as opposed to initiating a sweep, employing the discretionary pricing instructions of the d-Quote would not provide additional value to the customer being d-Quoted.<sup>98</sup>

With regard to the comments on the Exchange's proposed implementation schedule,<sup>99</sup> NYSE acknowledged that, given the complexity of the software developed for the d-Quote functionality and the extensive system changes required to enable increased automatic execution capabilities, it has not been able to launch all of these initiatives at the same time.<sup>100</sup> NYSE explained that floor brokers had requested the d-Quoting functionality well after the design of e-Quoting was completed and the necessary programming changes were scheduled. As a result, d-Quoting was initially slated for implementation as part of the last phase of the Hybrid Market. However, in response to requests from floor brokers, NYSE claimed that it has made every effort to move d-Quote implementation forward as much as possible. In addition, NYSE stated that it would be adding to the upcoming software releases a number of other changes recently requested by floor brokers, designed to improve the efficiency of the devices they use to access the market. Furthermore, NYSE maintained that the rollout of d-Quotes is timed to a program that provides ample training and trading practice for floor brokers using the new functionality. Accordingly, NYSE believes that the sheer volume of system and other required software changes, coupled with the need for appropriate training, mandates that the Exchange implement d-Quoting in two parts.<sup>101</sup> Finally, NYSE believes that the phase-in process would be sensitive to the varied needs of all market participants affected by the introduction of these complex changes, and that thorough and proper broker training and preparation for the d-Quote is essential, as it protects the broker from making unintended trading errors.

participate in the Hybrid Market if they were to send their orders through SuperDot).

<sup>97</sup> See IBAC Letter.

<sup>98</sup> See Response to Comments.

<sup>99</sup> See IBAC Letter.

<sup>100</sup> See Response to Comments.

<sup>101</sup> See Section III., D. for a complete discussion of the two-part implementation.

## V. Discussion

After careful review and consideration of the comments, 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>102</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>103</sup> in that the proposal is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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. Further, the Commission believes that the proposed rule change, as amended, is consistent with Section 11A(a)(1)(C) of the Act,<sup>104</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 markets; and (5) an opportunity for investors' orders to be executed without the participation of a dealer.

Currently in the NYSE auction, floor brokers represent their customers' orders for execution. For many orders, floor brokers have discretion to determine the price at which their customers' orders should be executed, subject to their agency obligations and best execution requirements. As the NYSE market becomes more automated, NYSE and its floor brokers have considered how floor brokers can continue to represent their customers in a meaningful fashion. NYSE continues to believe that its physical auction on the floor will play an important role in

<sup>102</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>103</sup> 15 U.S.C. 78f(b)(5).

<sup>104</sup> 15 U.S.C. 78k-1(a)(1)(C).

<sup>94</sup> See Response to Comments.

<sup>95</sup> But see Rutherford Letter III (arguing that participants entering public limit orders could only react to publicly available information).

<sup>96</sup> NYSE believes this solution was supported by floor brokers who worked with the Exchange in designing the e-Quote. See Response to Comments. But see Rutherford Letter III (arguing that NYSE's response is not providing a feasible means for a floor broker to protect its public customer from unnecessary specialist competition since, as a practical matter, floor brokers would not be able to

its market even as automated execution expands.

In the Hybrid Market, as approved, NYSE made provisions to allow its floor brokers to represent their customers in the electronic portion of the market. NYSE, however, also placed restrictions on their activities to reflect the continued role of the auction on the floor. Specifically, NYSE requires its floor brokers to be in the "Crowd" when representing customers electronically so that they can be available to represent their customers should the market move to the floor.

With this current proposal, NYSE proposes to give floor brokers more tools with which to represent their customers. NYSE represents that the discretionary instructions that it has proposed are intended to replicate the manner in which floor brokers represent orders in the auction. In addition, NYSE stated that d-Quotes will enable floor brokers to compete with other participants in an automated market place, including specialists, and may enhance the quality of order execution on the Exchange.

As discussed above, d-Quotes will enable floor brokers to place within the Display Book system, in a manner that is not displayed, the prices and sizes at which their customers are willing to trade if a contra side order arrives in the market. The d-Quote could enable floor brokers to better compete with other market participants, and possibly enhance the quality of order execution on the Exchange. The Commission believes that the Exchange's proposed d-Quote functionality is broadly consistent with the requirements of the Act, and within the realm of business judgment generally left to the discretion of individual markets.

The pegging function will enable floor brokers to remain in the Exchange BBO as the quote moves. As the markets become more electronic it may be very difficult for a floor broker to effectively manually adjust the prices of its customers' orders in the Display Book system. The Commission believes that the proposed pegging function should provide floor brokers with the ability to track the quote as it changes, thereby providing floor brokers with an additional tool to offer liquidity at the Exchange BBO, once the Exchange shifts from the manual auction market to a faster, predominantly electronic market. The pegging function also is designed to help them continuously meet one of the requirements for using the d-Quote—namely, maintaining an e-Quote at the NYSE BBO. Accordingly, the Commission finds that the proposal to implement a pegging function for floor

brokers is consistent with the requirements of the Act.

#### A. Comments

##### 1. Transparency

One commenter argued that the proposal would have an adverse impact on transparency because the discretionary instructions would not be disclosed to the public. The commenter argued that by not disclosing d-Quotes to the public, the Exchange was making its market less transparent to investors who seek liquidity and would be denying executions to investors who post liquidity. According to the commenter, the proposal would lessen incentives to post liquidity by allowing d-Quotes to trade despite the existence of displayed limit orders.

The commenter also argued that the lack of transparency of the d-Quotes would negatively impact the price discovery process by lessening the usefulness of the NBBO. The commenter argued that investors would be denied complete information about the current state of the prices and sizes at which other investors are willing to trade. Unlike the current auction where, according to the commenter, only interest that is disclosed is permitted to participate in an execution, d-Quotes will participate in an execution if their terms are fulfilled without disclosure to other market participants who may be willing to trade at the same or better price.

The Commission notes that it has never required complete disclosure of all trading interest, and that it has permitted the use of undisplayed order types. Today, for example, floor brokers may hold significant trading interest that may be available for execution that is not broadly disclosed, but that may participate in a transaction on the Exchange.

NYSE has proposed a means by which floor brokers can continue to represent customers without having to disclose the customers' entire orders. Floor brokers will be able to adjust their d-Quotes to reflect their customers' investment strategies.

The Commission believes that NYSE has designed its proposal to allow floor brokers to represent their customers in a manner similar to how they operate in the auction market. The Commission believes that the proposal is not likely to substantially reduce transparency because these orders are not currently displayed. The Commission also notes that it has approved similar undisplayed order types for use by other markets.<sup>105</sup>

<sup>105</sup> See Securities Exchange Act Release Nos. 47467 (March 7, 2003), 68 FR 12134 (March 13,

Accordingly, the Commission finds that the proposal is consistent with the Act.

##### 2. Informational Advantages for Floor Brokers

In the proposal, the Exchange states that it is intending to replicate, in the Hybrid Market, the manner in which floor brokers utilize their judgment in quoting and trading on behalf of their customers' orders in the auction market. One commenter questions whether the proposal actually replicates the auction market.<sup>106</sup> The commenter believes that the proposal would introduce a new manner of trading that is unfair to public limit orders and provides informational advantages to floor brokers. The commenter believes that the proposal would replicate the time and place advantage enjoyed by floor brokers in the auction market, without maintaining the counterbalance of the auction market's transparency of bids and offers, and the requirement that orders cannot trade before they are exposed to the market. Further, the commenter argued that floor brokers could enter their d-Quotes with full knowledge of the public limit orders, while public investors would not be provided reciprocal knowledge of the d-Quotes. Thus, the commenter believes that public investors are inappropriately denied the ability to change their limit prices in response to the trading instructions attached to d-Quotes.

In the Response to Comments, the Exchange noted that, without d-Quotes, investors that use floor brokers to represent their orders would not be able to access the Hybrid Market in a similar manner to which they access the auction market today. The Exchange believes that it designed the proposal to closely replicate the auction market in an electronic environment.

Further, the Exchange responds that in today's auction market, orders that are held and represented by floor brokers are not transparent. The Exchange represented that it designed the proposal to permit floor brokers to make the same types of trading decisions for the orders they hold in the Crowd today. The Exchange believes the

2003) (approving pegging orders in Pacific Exchange, Inc.) and 48798 (November 17, 2003), 68 FR 66147 (November 25, 2003) (approving pegging orders in Nasdaq Stock Market, Inc.); and 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (approving discretionary orders in Pacific Exchange, Inc.) and 49085 (January 15, 2004), 69 FR 3412 (January 23, 2004) (approving discretionary orders in Nasdaq Stock Market, Inc.). See also Securities Exchange Act Release No. 54511 (September 26, 2006), 71 FR 58460 (October 3, 2006) (approving passive liquidity order in NYSE Arca, Inc.).

<sup>106</sup> See Rutherford Letters I and III.



proposal would not substantially alter the amount of information currently available on the Exchange. Specialists and floor brokers would not have access to information about d-Quotes entered by other floor brokers. The Exchange also stated that public investors entering limit orders would have the same amount of information as is currently available, which does not include knowledge of floor broker trading interest. Likewise, floor brokers would not have any more market information on the Exchange than they do today.

Accordingly, the Commission does not believe that the proposal would provide floor brokers with an inappropriate informational advantage or reduce the amount of information that is currently publicly available.

### 3. Section 11A of the Act

One commenter argued that the proposal was inconsistent with Section 6(b) of the Act and Section 11A(a)(1)(C)(i) of the Act<sup>107</sup> because the commenter believes that the proposal is unfairly discriminatory and anti-competitive.<sup>108</sup> Specifically, the commenter argues that because the proposal would provide floor brokers with an exclusive right to enter d-Quotes, the proposal unfairly discriminates against customers who do not use floor brokers, and places a burden on competition that is not necessary in furtherance of the purposes of the Act. Further, the commenter argues that the proposal inhibits the economically efficient execution of orders, which Section 11A(a)(1)(C)(i) of the Act<sup>109</sup> states is a goal of the national market system. The commenter notes that, under the proposal, investors who seek to utilize discretionary instructions would be forced to pay a floor broker, who the commenter argues, then merely performs the clerical function of entering the order into the Exchange system for execution. The commenter believes that institutional investors should be free to exercise their own judgment without the requirement to employ any third parties. The commenter also noted that all market participants should have a fair opportunity to trade and trading should not be conducted with unnecessary human intervention.

The Commission notes that today if investors wish to have their orders represented in the NYSE auction market, they must either send their order to the Book for representation by a specialist or send their order to a floor

broker for representation.<sup>110</sup> In the Hybrid Market, NYSE has decided to retain a role for its floor members in its market. The commenter stated that he believed that "pure electronic trading is not only defensible but highly desirable" and thus, appears to fundamentally disagree with the market structure that NYSE has developed. However, Congress clearly contemplated that the markets should be able to compete through the adoption of different market models.<sup>111</sup>

NYSE has sought to replicate its current market in a more electronic manner, yet while retaining some distinctive features of its floor. As the Commission indicated in the Hybrid Market Order, the Exchange has a degree of flexibility to develop its market model so long as it does so within the framework of the Act.

The Commission believes that the proposal is broadly consistent with Section 11A of the Act in that it incorporates features that may provide investors with the opportunity to receive economically efficient execution of their securities transactions and promote fair and orderly markets.<sup>112</sup> The Commission believes that while d-Quotes would not be displayed, they could provide benefits to the market such as increased liquidity and improved prices. The Commission notes that undisplayed d-Quotes would never execute ahead of a displayed order that is at the same or better price.

A significant feature of the d-Quote is to potentially offer public investors a means, through the use of floor brokers, to compete with specialists in providing price improvement to incoming marketable orders. The Commission believes that d-Quote could provide meaningful competition to the specialist in providing price improvement, and thus promote competition on the Exchange floor.

Accordingly, the Commission does not believe that the proposal is inconsistent with Section 11A of the Act.<sup>113</sup>

<sup>110</sup> Small marketable limit orders can be automatically executed in Direct+.

<sup>111</sup> As Congress noted when it adopted the 1975 Act Amendments that it was "not the intention of the bill to force all markets for all securities into a single mold." See S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975). Congress instructed the Commission to seek to "enhance competition and to allow economic forces, interacting with a fair regulatory field, to arrive at appropriate variation in practices and services. It would obviously be contrary to this purpose to compel elimination of differences between types of markets or types of firms that might be competition-enhancing. *Id.*

<sup>112</sup> 15 U.S.C. 78k-1.

<sup>113</sup> 15 U.S.C. 78k-1.

### 4. Sweeps

In the Hybrid Market, once an auto ex order trades with interest at the Exchange BBO, the remainder, if any, would automatically sweep the Display Book system by trading with liquidity outside the BBO. Under the proposal, d-Quotes could also participate in sweeps initiated by other orders, but their discretionary instructions would not be active.<sup>114</sup> One commenter believes that a sweep initiated by other orders should not deactivate the discretionary instructions.<sup>115</sup> The Exchange responds that when a d-Quote is participating in a sweep, the discretionary functions would not provide additional value to the customer.

The Commission believes that the Exchange has some latitude to determine the types of functions that it believes would be most attractive to its market participants. Accordingly, the Commission believes that the treatment of d-Quote in sweeps is reasonable and broadly consistent with the requirements of the Act.

### 5. Implementation

The Exchange proposes to implement the d-Quote proposal in two parts, in Phase 3 and Phase 4 of the Hybrid Market implementation. One commenter argued that d-Quote should be implemented at the same time as the Specialist Algorithms, because the commenter believes that the proposal is necessary to maintain market balance.<sup>116</sup> The commenter believes that implementing the Specialist Algorithms first would risk a mass exodus of volume from the Exchange. In the Response to Comments, the Exchange stated that, due to the complexities of the system changes required by the implementation of the Hybrid Market, the Exchange is not able to launch the proposal at the same time as the Specialist Algorithms.

The Commission believes that the Exchange's proposed implementation schedule is reasonable and consistent with the requirements of the Act. The Commission notes that Phase 3 is when the Exchange anticipates switching to a substantially more automated market, and believes that the proposed staggered implementation schedule is reasonably designed to allow the Exchange to adequately test the changes to its systems.

### VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed

<sup>107</sup> 15 U.S.C. 78k-1(a)(1)(C)(i).

<sup>108</sup> See Rutherford Letters I and III.

<sup>109</sup> 15 U.S.C. 78k-1(a)(1)(C)(i).

<sup>114</sup> See proposed NYSE Rule 70.25(d)(ix).

<sup>115</sup> See IBAC Letter.

<sup>116</sup> See IBAC Letter.



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 Section 6(b)(5) of the Act<sup>117</sup> and Section 11A of the Act.<sup>118</sup>

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>119</sup> that the proposed rule change (SR-NYSE-2006-36) and Amendment Nos. 1 and 2 are approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>120</sup>

Nancy M. Morris,  
Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54578; File No. SR-NYSE-2006-82]

### Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change Relating to A Pilot Until 10/31/06 to Put Into Operation Certain Rule Changes Pending Before the Securities and Exchange Commission to Coincide With the Exchange's Implementation of Phase 3 of the NYSE HYBRID MARKET<sup>SM</sup>

October 5, 2006.

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> notice is hereby given that on October 5, 2006 the New York Stock Exchange LLC ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice and order to solicit comments on the proposed rule change from interested persons and to approve the proposed rule change on an accelerated basis.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange is proposing a pilot (the "Pilot") to put into operation certain rule changes pending before the

Commission to coincide with the Exchange's implementation of NYSE HYBRID MARKET<sup>SM</sup> ("Hybrid Market")<sup>3</sup> Phase 3 for the securities identified in Exhibit 3 of its filing. The text of the proposed rule change is available on NYSE's Web site (<http://www.nyse.com>), at the principal office of the Exchange, and at the Commission's Public Reference Room.

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NYSE included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The NYSE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

##### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

The Commission approved the Hybrid Market on March 22, 2006.<sup>4</sup> The approved rules did not become effective immediately; rather they are being implemented in a series of phases over a period of time.

Implementation of Phase 1 of the Hybrid Market, which focused primarily on the ability of Floor brokers to electronically represent their customers' interest ("e-Quote"), was substantially completed on April 5, 2006.

Phase 2 of the Hybrid Market focused primarily on the ability of specialists to use their algorithmic systems to quote and trade. The installation of software necessary to implement Phase 2 of the Hybrid Market has been installed Floor-wide. Some specialist firms have been in the process of readying their systems to quote and trade with receipt of order information, while others have begun quoting with receipt of such information. Phase 2 will continue to become operational concurrently with the roll out of Phase 3. In addition, beginning June 21, 2006, specialists were permitted to algorithmically quote ("s-Quote") in their specialty securities, without the receipt of order information

as such orders are entering Exchange systems.<sup>5</sup> Starting August 15, 2006, specialists were permitted to send algorithmically-generated trading messages to interact with the Exchange quotation ("hit bid/take offer"), also without receipt of order information as such orders are entering Exchange systems.<sup>6</sup>

Phase 3 of the Hybrid Market, as approved, includes implementation of the following features:

- 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 NYSE quotations that are not immediately available for automatic execution;
- Implementation of gap quoting requirements;
- Elimination of 1,099 size restriction for automatic executions and increase in size eligibility for automatic executions to 1 million shares;<sup>7</sup>
- Elimination of 30-second restriction on the entry of auto ex orders on 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 to auto ex orders; and
- Automatic executions of market orders.<sup>8</sup>

The Exchange intends to begin implementation of Phase 3 on October 6, 2006. The Exchange has proposed changes to some of the rules already approved for implementation in Phase 3<sup>9</sup> as well as moving the implementation of sweeps and liquidity replenishment points ("LRPs")

<sup>5</sup> See Securities Exchange Act Release No. 54024 (June 21, 2006), 71 FR 36849 (June 28, 2006) (SR-NYSE-2006-44). This is effective until Phase 2 is fully implemented.

<sup>6</sup> See Securities Exchange Act Release No. 54316 (August 15, 2006), 71 FR 48569 (August 21, 2006) (SR-NYSE-2006-59). This is effective until Phase 2 is fully implemented.

<sup>7</sup> See Securities Exchange Act Release No. 54520 (September 27, 2006), 71 FR 57590 (September 29, 2006) (SR-NYSE-2006-65) (proposing to amend several Exchange Rules to clarify certain definitions and systemic processes ("Omnibus Filing")).

<sup>8</sup> *Id.*

<sup>9</sup> See Omnibus Filing.

<sup>117</sup> 15 U.S.C. 78f(b)(5).

<sup>118</sup> 15 U.S.C. 78k-1.

<sup>119</sup> 15 U.S.C. 78s(b)(2).

<sup>120</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> The Hybrid Market was approved on March 22, 2006. See Securities Exchange Act Release No. 53539 (March 22, 2006), 71 FR 16353 (March 31, 2006) (SR-NYSE-2004-05) ("Hybrid Market Order").

<sup>4</sup> *Id.*