

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-58328; File No. SR-NYSE-2008-45)

August 7, 2008

Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change, as Modified by Amendment No. 1 Thereto, Amending NYSE Rule 98 and Related Rules to Redefine Specialist Operations at the NYSE

I. Introduction

On June 11, 2008, the New York Stock Exchange LLC (“NYSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NYSE Rule 98 and related rules to allow its member organizations greater flexibility in structuring their specialist operations and managing their risk. The proposed rule change was published for comment in the Federal Register on July 3, 2008.³ On August 7, 2008, the NYSE filed Amendment No. 1 to the proposed rule change.⁴ The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

II. Background and Introduction

The NYSE adopted NYSE Rule 98 in 1986 when NYSE specialist firms, which had been independent member-owned entities, were increasingly becoming affiliates of larger member

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 58052 (June 27, 2008), 73 FR 38274 (“Notice”).

⁴ In Amendment No. 1, the NYSE revises the text of proposed NYSE Rule 460.10 to conform it to the description of proposed NYSE Rule 460.10 as set forth in the Notice. Because Amendment No. 1 is technical in nature, the Commission is not publishing it for comment.

organizations.⁵ Because of the specialists' unique position in the market, NYSE Rule 98 requires an organizational separation between the specialist and any affiliates. The purpose of that separation is to eliminate or control conflicts of interest between the specialist's responsibilities to the market and to any customer orders the specialist may represent as agent, and the business activities of the specialist's affiliates.

NYSE Rule 98 currently applies to specialist organizations and "approved persons" of specialist organizations. "Approved persons" are entities that are in a control relationship with a specialist organization, or share a common corporate parent with the specialist organization and are engaged in a kindred business.⁶ NYSE Rule 98 subjects all approved persons of a specialist organization to the NYSE specialist rules. Among other things, approved persons are subject to restrictions on their ability to trade in specialty stock options, restrictions on certain of their business transactions with issuers for whom the specialist organization is the registered specialist, and limits on the amount of securities of such issuers that the specialist and approved persons may own in the aggregate.

To avoid unnecessarily restricting a member organization's overall operations, however, the current rules provide that each approved person may separately seek NYSE approval to be exempted from most of these restrictions. To obtain such an exemption, an approved person and the specialist member organization with which such approved person is to be associated must obtain the written agreement of NYSE Regulation, Inc. ("NYSE Regulation") that the approved person and such member organization have established policies and procedures that are consistent with the guidelines prescribed by NYSE Rule 98. These guidelines set out in detail

⁵ See Securities Exchange Act Release No. 23768 (November 3, 1986), 51 FR 41183 (November 13, 1986) (SR-NYSE-85-25).

⁶ See NYSE Rules 2(d) and 304(e).

how approved persons and their associated specialist organizations should structure and conduct their respective businesses in order to ensure complete separation between the specialist organization and the rest of the member organization. For example, these guidelines require (1) the specialist unit to be housed in a separate corporate entity and broker-dealer from its approved persons; (2) the maintenance of separate books and records, financial accounting, and required capital by the specialist unit; and (3) procedures to safeguard confidential information derived from business interactions with the issuer or contained in draft research reports prepared by the approved person.

NYSE Rule 98 currently limits the ability of a specialist member organization and its approved persons to share operational support personnel, and permits dual affiliation only if the specialist member organization and approved person provide the Exchange with a written statement of the duties of such person and why it is necessary for the individual to have a dual affiliation. Any changes to dual affiliations must be submitted to the Exchange for approval in advance of making such change.

The current NYSE rules also limit the ability of a specialist, its member organization, and approved persons to manage the specialist member organization's trading risks. Specifically, NYSE Rule 98 restricts an approved person from being involved in any trading decisions of an associated specialist member organization and NYSE Rule 105 restricts the specialist member organization's ability to trade in options and security futures on securities allocated to the specialist member organization.

The NYSE believes that NYSE Rule 98 creates an administrative burden on specialist organizations and their approved persons because each approved person must continually update a separate exemption for each activity that would otherwise be restricted. The NYSE also

believes that its current rule unnecessarily constrains the ability of specialist organizations and their approved persons to manage the specialist organization's risks and places them at a competitive disadvantage vis-à-vis other market making or trading firms. Accordingly, the NYSE proposes to amend NYSE Rule 98 to provide member organizations with more flexibility with regard to how they structure their specialist operations and manage risk. NYSE also proposes to make conforming changes to other NYSE rules that rely on the NYSE Rule 98 exemptions for approved persons.

As discussed in further detail below, the revisions to NYSE Rule 98 would include: (1) redefining the persons to whom NYSE Rule 98 would apply; (2) allowing specialist operations to be integrated into a member organization; (3) permitting a specialist unit to share non-trading related services with its member organization or approved persons; and (4) providing flexibility to member organizations and their approved persons in how to conduct risk management of specialist operations.

After careful review, and as discussed below, 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.⁷ In particular, the Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act,⁸ which requires that the rules of the an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national securities system, and, in general, to protect investors and the public interest.

⁷ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78f(b)(5).

The restrictions in current NYSE Rule 98 and related rules are intended to address two primary concerns. The first concern is the potential that an affiliate could unfairly use non-public information, such as information on a specialist's book or information regularly provided to him by other market participants because of his central role as a primary market specialist. If a specialist's affiliates had access to such information, it would have a perceived advantage over competing firms and the public at large in trading stocks assigned to the affiliated specialist. The same concern about the potential for unfair use of non-public information would arise if the specialist had advance information about the activities of its affiliates (e.g., a change in the firm's buy or sell recommendation or an imminent block transaction away from the market). Access to such information would allow the specialist to position itself to benefit from price changes that might result once that information became publicly available. The second concern is that a specialist unit could favor its affiliates by providing orders placed by the affiliate with more favorable executions and by providing useful market information to the affiliated firm (or to its broker on the exchange trading floor) but not to others. In some cases, such conflicts of interest could result in the specialist neglecting his duty to make a fair and orderly market by giving an affiliate's principal or agency orders a more favorable execution.

The potential for misuse of non-public information and conflicts of interest, if not addressed by appropriate procedures and the monitoring and surveillance of the continuing adequacy of such procedures, could result in potential manipulative market activity and informational advantages benefiting the approved person, the specialist unit, or the customers of either. As discussed in more detail below, the Commission believes that the changes NYSE proposes to make to NYSE Rule 98 and related rules address these concerns.

III. Proposed Amendments to NYSE Rule 98

In response to concerns described above with current NYSE Rule 98, NYSE proposes a wholesale change to NYSE Rule 98 that would apply a more principles-based approach. In addition, under the proposed rule, instead of reviewing whether to grant each approved person an exemption from NYSE Rule 98, NYSE Regulation would review whether the specialist unit itself has adequate policies, procedures, controls, and surveillance designed to prevent the misuse of specialist confidential information⁹ and non-public order¹⁰ information. If the specialist unit has such policies, procedures, controls, and surveillance, the specialist rules would generally only be applicable to the specialist unit and not to affiliates of the specialist. In addition to the information barriers and other NYSE Regulation approved controls, specialists would continue to be subject to Exchange rules that govern their access to and use of non-public order information.¹¹

A. Operating a Specialist Unit

Under proposed NYSE Rule 98(c), a member organization must obtain prior written approval from NYSE Regulation to operate a specialist unit. To obtain such approval, NYSE

⁹ “Specialist confidential information” means any non-public information relating to a specialist unit’s trading or quoting in its specialty securities, including positions or any other indication of a specialist’s trading or quoting interest, the specialist algorithm, or any other public information relating to a specialist’s interactions with its specialist security, but not including non-public order information. See proposed NYSE Rule 98(b)(6).

¹⁰ A “Non-public order” is an order, whether expressed electronically or verbally, or any information regarding a reasonably imminent non-public transaction or series of transactions entered or intended for entry or execution on the NYSE and which is not publicly available on a real-time basis via an NYSE-provided data-feed. See proposed NYSE Rule 98(b)(7).

¹¹ See, e.g., NYSE Rules 70.20(h)(ii), 104(b), 115, and 115A.

Regulation would have to determine that the specialist unit has: (i) adopted and implemented comprehensive written procedures and guidelines governing the conduct and supervision of business handled by the specialist unit; (ii) established a process for regular review of such written policies and procedures; and (iii) implemented controls and surveillances reasonably designed to prevent and detect violations of these procedures and guidelines. These policies and procedures would have to be reasonably designed to maintain the confidentiality of specialist confidential information and non-public order information. In this regard, proposed NYSE Rule 98(c) would require a member organization's policies and procedures to prohibit approved persons and the member organization's departments, divisions, or aggregation units that are not part of the specialist unit from having access to specialist confidential information and non-public order information.¹² In addition, such policies and procedures would have to prohibit a specialist unit from having access to material non-public order information in the possession of other aggregation units of the member organization related to the securities allocated to that specialist unit.¹³

Further, a specialist unit that is not operated as part of an integrated proprietary aggregation unit would have to comply with all the requirements of an aggregation unit.¹⁴ Accordingly, as required by Rule 200(f) of Regulation SHO, such a specialist unit would have to

¹² However, a specialist may make available to a Floor broker associated or affiliated with an approved person or member organization any information that the specialist would be permitted to provide under Exchange rules to an unaffiliated Floor broker. See proposed NYSE Rule 98(c)(2)(A)(ii).

¹³ See proposed NYSE Rules 98(c)(1) and (c)(2).

¹⁴ See proposed NYSE Rules 98(b)(11) and 98(c)(2)(B).

have a written plan of organization that specifies its trading objectives and meets all the other requirements of an independent trading unit under Regulation SHO.¹⁵

The proposed rule would permit senior managers who are not dedicated to the specialist unit and are associated with either an approved person or a member organization that runs a specialist unit to provide management oversight to the specialist unit. A member organization's policies and procedures would need to be reasonably designed to ensure that such management oversight does not conflict with or compromise the specialist unit's compliance with the specialist rules. The proposed rule would also provide specific guidelines for access by the senior managers not assigned to the specialist unit to specialist confidential information or non-public order information, which are designed to prevent the misuse of such information. For example, proposed NYSE Rule 98(c)(2)(E) would provide that if a senior manager is called upon for risk management purposes and gains access to specialist confidential information or non-public order information in connection with that role, the senior manager must not make (directly or indirectly) specialist confidential information or non-public order information available to the persons or systems responsible for making trading decisions in aggregation units, departments, divisions, or trading desks that are not part of the specialist unit, including the customer-facing departments. The senior manager also must not use such information to directly or indirectly influence the day-to-day trading decisions of the other aggregation units of the member organization or approved person with respect to the securities allocated to the specialist unit.¹⁶

¹⁵ See 17 CFR 242.200(f). To be exempt from the restrictions in NYSE Rule 105 pursuant to proposed Rule 98(f)(1), the written plan of organization required by Rule 200(f) of Regulation SHO would need to specify the specialist unit's trading objectives for trading in related products.

¹⁶ See proposed NYSE Rule 98(c)(2)(E). See Notice, supra note 3, at 73 FR at 38278.

Proposed NYSE Rule 98(c) would enumerate certain bright line divisions that the specialist unit must maintain, including information barriers between the specialist unit and investment banking, research, and customer-facing departments and approved persons. These divisions are designed to ensure that the specialist unit cannot access material non-public information about securities allocated to that unit from either its approved persons or non-specialist operations of a parent member organization.¹⁷ In addition, as discussed above, these divisions are designed to ensure that a member organization's departments, divisions, or aggregation units not part of the specialist unit, including investment banking, research, and customer-facing departments, cannot access specialist confidential information or non-public order information.¹⁸ Finally, a specialist unit would be required to maintain or have allocated to it net capital sufficient to meet the requirements of NYSE Rule 104.21.¹⁹

NYSE Regulation would review a member organization's surveillance plans and internal controls to ensure that they are reasonably designed to protect information as required under the proposed rule. As with the current rule, NYSE Regulation would also review whether a member organization has implemented internal audit procedures to ensure compliance with such organization's NYSE Rule 98 policies and procedures. The Exchange represents that the NYSE Regulation review for approving a specialist unit would be as rigorous as the current review for obtaining an exemption from current NYSE Rule 98.²⁰ As with the current NYSE Rule 98 exemption process, staff from both the Market Surveillance Division of NYSE Regulation, as well as staff from the Financial Industry Regulatory Authority, Inc. ("FINRA") who are

¹⁷ See proposed NYSE Rule 98(c)(2)(C).

¹⁸ See proposed NYSE Rule 98(c)(2)(A)(i) and supra notes 12 and 13 and accompanying text.

¹⁹ See proposed NYSE Rule 98(c)(2)(D).

²⁰ See Notice, supra note 3, at 73 FR at 38278.

responsible for the routine examinations of specialist units, would be involved in reviewing a specialist unit's written policies and procedures and proposed automated surveillances and controls.²¹

After a member organization has been approved to operate a specialist unit, NYSE Regulation and FINRA would conduct examinations to determine whether a specialist unit's policies and procedures continue to meet the rule requirements and whether the controls and automated surveillances are functioning as designed. As part of the examinations, NYSE Regulation and FINRA would conduct on-site reviews of a specialist unit to review for breaches of the controls or surveillances.²² In addition, NYSE states that a specialist unit would need to seek approval from NYSE Regulation, before making any material changes to its operations.²³

The Commission finds that the requirements in proposed Rule 98(c) are consistent with the Act. The Commission believes that the proposed rule change, as amended, establishes guidelines for a member organization's policies and procedures that will protect against the improper disclosure and sharing of specialist confidential information and non-public order information.

B. Operating a Specialist Unit Within an Integrated Proprietary Aggregation Unit

Proposed NYSE Rule 98 would permit a member organization to seek approval to operate a specialist unit within an integrated proprietary aggregation unit. An "integrated proprietary aggregation unit" is proposed to be defined to mean a department, division, or desk

²¹ See Notice, supra note 3, at 73 FR at 38279. In the Notice, the Exchange stated that "[w]here feasible, NYSE Regulation will expect specialist units to use automated surveillances to check for breaches of the information barriers required by the proposed rule." Id.

²² Id.

²³ Id.

that meets the requirements of the definition of an “independent trading unit” under Rule 200 of Regulation SHO with a trading objective to engage in proprietary trading, including market-making activities.²⁴ An integrated proprietary aggregation unit must be separate from any investment banking, research, or customer-facing department.²⁵

To protect specialist confidential information and non-public order information, a member organization would be permitted to operate a specialist unit within an integrated proprietary aggregation unit, if NYSE Regulation approves such operations and the member organization: (i) adopts and implements comprehensive written procedures and guidelines governing the conduct and supervision of business handled by the unit; (ii) establishes a process for regular review of such written policies and procedures; and (iii) implements controls and surveillances reasonably designed to prevent and detect violations of these procedures and guidelines.²⁶

In addition, to operate a specialist unit within an integrated proprietary aggregation unit, the specialist unit’s policies and procedures would have to meet those requirements for operating a specialist unit pertaining to information barriers associated with the specialist unit and non-specialist unit operations, net capital requirements, and senior management oversight.²⁷ A specialist unit operating within an integrated proprietary aggregation unit would not be required to separately comply with all requirements of a Regulation SHO independent trading unit

²⁴ See proposed NYSE Rule 98(b)(11) and (14); 17 CFR 242.200(f).

²⁵ See proposed NYSE Rule 98(b)(14).

²⁶ See proposed NYSE Rule 98(d)(1) and (2).

²⁷ See proposed NYSE Rules 98(d)(2)(A) and 98(c)(2)(A), (C), (D), and (E).

because the integrated proprietary aggregation unit of which it is a part would be required to comply with Rule 200(f) of Regulation SHO.²⁸

The member organization's policies and procedures would also need to restrict access within the integrated proprietary aggregation unit to non-public order information. Specifically, except for senior managers pursuant to policies and procedures adopted under proposed NYSE Rule 98(c)(2)(E), the specialist unit must not permit systems and individuals not assigned to the specialist unit to have access to non-public order information.²⁹ For example, because the specialist application protocol interface ("specialist API") currently has access to non-public order information, systems not dedicated to the specialist unit could not be integrated with the specialist API. Accordingly, the trading algorithms of the integrated proprietary aggregation unit that are not dedicated to the specialist unit must not have access to any non-public order information via the specialist API, or any other system.³⁰

A member organization's policies and procedures would have to prohibit individuals assigned to the specialist unit, while on the Exchange floor,³¹ from communicating with individuals or systems responsible for making trading decisions for the integrated proprietary

²⁸ See supra note 24 and accompanying text. The Exchange states that there may be some Regulation SHO issues in connection with how a member organization may choose to structure its specialist unit within an integrated proprietary aggregation unit or provide risk management to the specialist unit pursuant to proposed NYSE Rule 98(f). Accordingly, the Exchange represents that it would not approve a specialist unit to operate under proposed NYSE Rule 98 until all Regulation SHO issues that may arise have been resolved. See Notice, supra note 3, at 73 FR at 38279.

²⁹ See proposed NYSE Rule 98(d)(2)(B)(i) and (ii).

³⁰ See Notice, supra note 3, at 73 FR 38279.

³¹ NYSE rules define being on the Floor to include the trading Floor of the Exchange, and the premises immediately adjacent thereto, such as the various entrances and lobbies of 11 Wall Street, 18 New Street, 12 Broad Street, and 18 Broad Street, as well as the telephone lobby in the first basement of 11 Wall Street. See NYSE Rule 112(b).

aggregation unit.³² However, such policies and procedures could permit a specialist unit employee to move, on an intra-day basis, to an off-Floor location and engage in a non-specialist related role within the integrated proprietary aggregation unit.³³ The policies and procedures of a member organization that chooses to allow individuals to so move must be reasonably designed to prohibit such individual from (1) making any non-public order information or specialist confidential information available to individuals or systems responsible for making trading decisions for the integrated proprietary aggregation unit and (2) using any non-public order information or, except for certain risk management activities as described below,³⁴ specialist confidential information in connection with making trading decisions for the integrated proprietary aggregation unit.³⁵

Proposed NYSE Rule 98 would no longer require separate books and records for a specialist unit operating within an integrated proprietary aggregation unit. However, to allow NYSE Regulation to review the trading activity by the specialist unit at the Exchange without having to parse through commingled records, under proposed NYSE Rule 98(d)(2)(C), an integrated proprietary aggregation unit would have to maintain records of its specialist's accounts in a manner that is separate from the accounts of the integrated proprietary aggregation unit.³⁶ Similarly, to ensure that NYSE Regulation can review the trading activities of the integrated proprietary aggregation unit, proposed NYSE Rule 98(d)(4) would require an integrated proprietary aggregation unit to maintain audit trail information for any trading by such

³² See proposed NYSE Rule 98(d)(2)(B)(iii).

³³ See proposed NYSE Rule 98(d)(2)(B)(iv).

³⁴ See Section III(D) infra.

³⁵ See proposed NYSE Rule 98(d)(2)(B)(iv).

³⁶ See NYSE Rule 98(d)(2)(C).

unit, including trading at the Exchange and at other market centers. Further, the proposed amendments to NYSE Rule 132B would apply the Order Tracking System (“OTS”) requirements to trading by a specialist unit, and if applicable, an integrated proprietary aggregation unit.³⁷ A member organization would be required to maintain sufficient records to reconstruct in a time-sequenced manner its trading in securities allocated to the specialist unit and any trading by the integrated proprietary aggregation unit in those securities in other market centers or trading in related products.³⁸

The Commission finds that the NYSE’s proposal to permit a member organization to operate a specialist unit within an integrated proprietary aggregation unit is consistent with the Act. The Commission believes that the guidelines established for member organization policies and procedures and NYSE Regulation review are designed to protect specialist confidential information and non-public order information and mitigate the potential for conflicts of interest in a member organization. The Commission also believes that operation of a specialist unit within an integrated proprietary aggregation unit need not interfere with the specialist’s obligations under Exchange Rules. In particular, proposed NYSE Rule 98(d) would establish that the specialist rules would apply to any trading on or through the systems and facilities of the Exchange by the integrated proprietary aggregation unit through the specialist unit in the securities that are allocated to the specialist unit and to the integrated proprietary aggregation unit if the integrated proprietary aggregation unit causes the specialist unit to violate the

³⁷ The order tracking provisions in NYSE Rule 132B currently do not apply to members effecting on the Floor proprietary transactions when they are acting in the capacity of a specialist, a Registered Competitive Market Maker, or a Competitive Trader. The proposed amendments in NYSE Rule 132B would apply the order tracking provisions in the rule to those persons.

³⁸ See proposed NYSE Rule 98(d)(4).

specialist rules.³⁹ In this regard, NYSE states that if there is a conflict between the specialist unit's market making obligations and the integrated proprietary aggregation unit's trading, the presumption would be in favor of the specialist unit's market making obligations.⁴⁰

C. Sharing Non-Trading Related Services

Proposed NYSE Rule 98(e) would allow a specialist member organization and its approved persons to share non-trading related services, subject to the approval of NYSE Regulation. To obtain approval to share non-trading related services, the specialist unit would be required to: (i) adopt written policies and procedures governing the sharing of non-trading related services; (ii) establish a process for regular review of such written policies and procedures; and (iii) implement controls and surveillances reasonably designed to prevent and detect violations of those policies and procedures. At a minimum, the specialist unit's policies and procedures would have to be reasonably designed to provide that the specialist unit and the member organization or approved person must maintain the confidentiality of specialist confidential information and non-public order information. Under no circumstances may non-public order information or specialist confidential information be made available to a member's organizations investment banking, research, or customer-facing departments.⁴¹

The Commission finds that NYSE's proposal to allow a specialist unit to share certain non-trading related services with its member organization or approved person is consistent with the Act because such sharing would be conducted pursuant to policies and procedures designed to protect specialist confidential information and non-public order information. Moreover, such policies and procedures would be reviewed by NYSE Regulation prior to a member organization

³⁹ See proposed NYSE Rule 98(d)(3).

⁴⁰ See Notice, supra note 3, at 73 FR at 38280.

⁴¹ See NYSE Rule 98(e)(2).

being approved to share non-trading related services and NYSE Regulation and FINRA would examine on an ongoing basis whether the specialist unit's policies and procedures and controls comply with the requirements of the rule.⁴²

D. Risk Management

1. Changes to NYSE Rule 105

NYSE Rule 105 currently limits the ability of specialists, specialist organizations and approved persons (and any officer or employee thereof) to conduct risk management trading in options and single stock futures on stock in which the specialist is registered. The Guidelines for Specialists' Specialty Stock Option and Single Stock Futures Transactions Pursuant to Rule 105 ("Rule 105 Guidelines") currently sets forth the permissible options positions that a specialist may establish and maintain for the purpose of hedging risks associated with holding specialty stocks. The proposed amendments to NYSE Rule 105 would limit the applicability of the rule to the specialist unit itself (and any officer or employee thereof); approved persons would no longer be subject to NYSE Rule 105.⁴³

Paragraph (m)(i) of the Rule 105 Guidelines currently prohibits specialists, their member organization and their approved persons (or officer or employee thereof) from acting in any market-making capacity in an option or security future overlying a security in which the specialist is registered. An approved person may seek an exception from these restrictions under NYSE Rule 98 and paragraphs (m)(ii) and (iii) of the Rule 105 Guidelines exempt such approved person to engage in such market making activities. Such approved person, however, may not

⁴² See Notice, supra note 3, at 73 FR 38281.

⁴³ NYSE Rule 105(a), which prohibits specialists, their member organization and their approved persons (or officer or employee thereof) from being directly or indirectly interested in a pool dealing or trading in a stock in which such member is registered as a specialist, would continue to apply to approved persons.

also act as a market maker in any equity security in which the associated specialist is registered and which underlies an option or security future in which the approved person is acting as market maker.⁴⁴

Consistent with the proposal to amend NYSE Rule 105 so that approved persons are no longer subject to the Rule, the proposed rule change would eliminate the reference to “approved persons” in paragraph (m)(i) of the Rule 105 Guidelines. Thus, an approved person and an integrated proprietary aggregation unit would not be prohibited by NYSE Rules from engaging in options or security futures market making activities. In addition, the proposed rule change would delete paragraphs (m)(ii) and (m)(iii), which apply only to approved persons, from the Rule 105 Guidelines.

The Commission believes that these proposed changes to NYSE Rule 105 and the Rule 105 Guidelines are consistent with the Act. Under proposed NYSE Rule 98, the specialist unit would be walled-off from approved persons pursuant to a member organization’s policies and procedures reviewed by NYSE Regulation that must be reasonably designed to protect against the improper disclosure and sharing of specialist confidential information and non-public order information. The Commission believes that these barriers between the specialist unit and other business activities of a member organization, including market making in securities in which a specialist is registered and related securities, will limit the potential for unfair use of non-public order information, manipulation and other improper trading practices, and conflicts of interest.

2. Proposed Risk Management Models

Proposed NYSE Rule 98(f) would broaden the ability of specialist units to trade in related products and expand the universe of who may be involved in managing the risk of the specialist

⁴⁴ Paragraph (m)(ii) of the Rule 105 Guidelines.

unit. In this regard, the NYSE proposes three models for a specialist unit to set up its risk management operation. Specifically, under the first model, risk management may be conducted within the specialist unit itself.⁴⁵ Under the second model, risk management may be conducted within an integrated proprietary aggregation unit.⁴⁶ Under the third model, risk management may be conducted within another affiliate of the specialist unit.⁴⁷ Regardless of the risk management model, the specialist unit would be responsible for its quoting or trading decisions at the Exchange.⁴⁸

a. Specialist Unit Risk Management

NYSE Rule 105 limits a specialist unit's trading in options and single stock futures on stock in which the specialist is registered. Proposed NYSE Rule 98(f)(1) would allow a specialist unit to seek an exemption from NYSE Rule 105 for the purpose of conducting risk management trading. A specialist unit and its officers and employees would continue to be prohibited from engaging in any capacity as a market maker in options or security futures overlying securities in which the specialist is registered. To obtain an exemption from the NYSE Rule 105 restrictions, the specialist unit would have to: (i) adopt and implement comprehensive written procedures and guidelines governing the conduct of trading in related products; (ii) establish a process for regular review of such written procedures and guidelines; and (iii) implement controls and surveillances reasonably designed to prevent and detect violations of these procedures and guidelines. These policies and procedures would have to be reasonably designed to ensure that the individuals or systems responsible for trading related products do not

⁴⁵ See proposed NYSE Rule 98(f)(1).

⁴⁶ See proposed NYSE Rule 98(f)(2).

⁴⁷ See proposed NYSE Rule 98(f)(3).

⁴⁸ See Notice, supra note 3, at 73 FR at 38281; see also proposed NYSE Rules 98(f)(2)(A)(i) and 98(f)(3)(C)(iv).

have access to non-public order information or except as described below,⁴⁹ specialist confidential information.⁵⁰ Individuals who work on the Exchange Floor would not be permitted to trade or direct trading in related products,⁵¹ nor would the specialist API be permitted to make any trading decisions in related products.⁵² Accordingly, any trading in related products by the specialist unit would have to be conducted by an off-Floor, i.e., “upstairs” office, by individuals who are qualified and registered to trade in the marketplaces where such trading occurs.⁵³

The NYSE proposes to allow individuals or systems responsible for trading related products to have limited access to specialist confidential information. Specifically, individuals or systems, including computer algorithms, responsible for making trading decisions in related products may have electronic access to the specialist unit’s trades at the Exchange in securities

⁴⁹ See infra notes 55 - 56 and accompanying text.

⁵⁰ The proposed rule change would permit a specialist unit to transfer a specialist back and forth from the Floor of the Exchange to a specialist unit desk upstairs that trades in related products, so long as that specialist is registered and qualified to trade in related products and non-public order information is not used when trading in related products. In such case, however, a specialist unit must have policies and procedures reasonably designed to ensure that a specialist who moves off the Floor of the Exchange does not make available or use any non-public information or, unless otherwise specified, specialist confidential information, to which the specialist may have had access while on the Floor of the Exchange. See proposed NYSE Rule 98(f)(1)(A)(iii).

⁵¹ See proposed NYSE Rule 98(f)(1)(A)(ii); Notice, supra note 3, at 73 FR at 38281.

⁵² See proposed NYSE Rule 98(f)(1)(A)(iv). Under the proposal, a specialist unit that has not been approved for an exemption from NYSE Rule 105 would still be permitted to enter orders in options or single-stock futures from the Floor, subject to the requirements of NYSE Rule 105; see also Notice, supra note 3, at 73 FR at 38281.

⁵³ The Exchange notes that the member organization with the specialist unit would have to be a member of FINRA or another self-regulatory organization, as required by each marketplace where the specialist unit proposes to trade. See Notice, supra note 3, at 73 FR at 38281.

allocated to the specialist unit, provided that such trades have been printed to the Consolidated Tape.⁵⁴

In addition, a senior manager of the specialist unit would be permitted to provide risk management oversight of both Floor specialist operations and any specialist unit upstairs trading in related products.⁵⁵ Such oversight, however, would have to be done pursuant to policies and procedures reasonably designed to prevent the specialist unit senior managers who have access to non-public order information or specialist confidential information from making such information available to the individuals or systems on the upstairs trading desk responsible for trading related products within the specialist unit or using such information to directly or indirectly influence trading in related products by that upstairs desk.⁵⁶ The proposed rule also would bar specialists from directly entering or executing trades in related products while on the Floor of the Exchange.⁵⁷

The Commission believes that the proposal to permit a specialist unit to conduct risk management within the specialist unit itself is consistent with the Act. The Commission notes that the proposed rule would require a specialist unit's policies and procedures to be reasonably designed to ensure that the individuals or systems responsible for trading related products do not have access to non-public order information or, except under limited conditions, specialist confidential information.

The Commission believes that those limited circumstances in which specialist confidential information may be used to manage a specialist unit's risks would not be a misuse of

⁵⁴ See proposed NYSE Rule 98(f)(1)(A)(v).

⁵⁵ See proposed NYSE Rule 98(f)(1)(A)(vi).

⁵⁶ Id.

⁵⁷ See proposed NYSE Rule 98(f)(1)(ii).

information. The Commission does not believe that information about trades that have been printed to the Consolidated Tape would provide the member organization with an unfair advantage because such trades would be publicly available.⁵⁸

b. Integrated Proprietary Aggregation Unit Risk Management

Proposed NYSE Rule 98(f)(2) would permit an integrated proprietary aggregation unit to conduct risk management trading related to the specialist unit's trading.⁵⁹ NYSE Regulation would need to approve the integrated proprietary aggregation unit to conduct such risk management trading.

Proposed NYSE Rule 98(f)(2) incorporates the requirements described above for conducting risk management trading within the specialist unit itself, except for the requirement in proposed NYSE Rule 98(f)(1)(A)(vi) relating to senior managers of the specialist unit.⁶⁰ The requirement in proposed NYSE Rule 98(f)(1)(A)(vi) is not applicable where risk management is being conducted by an integrated proprietary aggregation unit, because senior managers of the specialist unit would not be providing risk management oversight. In addition, an integrated proprietary aggregation unit would be required to: (i) adopt and implement comprehensive written procedures and guidelines governing the conduct of risk management of the specialist

⁵⁸ Once trades are disseminated publicly, the individuals or systems, including computer algorithms, responsible for trading in related products may have access to the specialist unit's aggregate net long or short position that includes the printed trades.

⁵⁹ An integrated proprietary aggregation unit conducting risk management trading outside of its specialist unit pursuant to proposed NYSE Rule 98(f)(2) would not require an exemption from the requirements of NYSE Rule 105(b)-(d) and the Rule 105 Guidelines because, under the proposed changes to NYSE Rule 105, the prohibitions on risk management trading would apply only to the specialist unit itself and not to approved persons. See supra Section III(D)(1).

⁶⁰ See proposed NYSE Rule 98(f)(2)(A). An integrated proprietary aggregation units would have to meet the requirements of proposed NYSE Rule 98(f)(1)(A)(i) – (v), see supra notes 49 - 54 and accompanying text.

unit; (ii) establish a process for regular review of such written procedures and guidelines; and (iii) implement controls and surveillances reasonably designed to prevent and detect violations of these procedures and guidelines.

Rule 98 (f)(2)(A)(i) would permit the “upstairs” risk management desk to electronically direct the specialist unit’s trading or quoting, subject to the specialist unit’s market making obligations. To provide the recommendations to the specialist unit, the “upstairs” risk management desk would be permitted to have real-time access both to the integrated proprietary aggregation unit’s positions in related products and other securities and to the specialist unit’s positions in securities allocated to it, provided that such specialist unit’s positions comprise only trades that have been printed to the Consolidated Tape.⁶¹

The Commission finds that the proposal to permit a specialist unit’s risk management operations to be performed by an integrated proprietary aggregation unit of which it is part is consistent with the Act. The Commission believes that the policies and procedures an integrated proprietary aggregation unit would be required to establish and that NYSE Regulation would need to review would protect specialist confidential information and non-public order information.

The Commission also believes that the proposed NYSE Rule 98 would continue to mitigate conflicts of interest between the specialist’s responsibilities to the market and the business activities of specialist affiliates. In this regard, the proposed rule would require the specialist unit to determine whether any recommendations provided to it by an “upstairs” risk management desk are consistent with its market making obligations, including Exchange

⁶¹ See Notice, supra note 3, at 73 FR at 38282; see also proposed Rule 98(f)(2)(A)(i).

specialist rules. Thus, the Commission expects that the specialist unit would accept or reject such recommendations in a manner that is consistent with its market making obligations.

c. Approved Person or Member Organization Risk Management

Finally, under proposed NYSE Rule 98(f)(3) an approved person or a member organization that runs a specialist unit could seek approval of NYSE Regulation to conduct risk management trading related to the specialist unit's trading.⁶² This alternative would provide broker-dealers the flexibility to keep the specialist unit as a separate member organization or aggregation unit, yet have an approved person or separate aggregation unit provide risk management services for the specialist unit. Under this option, the approved person or member organization would provide the same type of risk management as an integrated proprietary aggregation unit that includes that the specialist unit under proposed NYSE Rule 98(f)(2). Thus, as required for an integrated proprietary aggregation unit under proposed NYSE Rule 98(f)(2) described above, proposed NYSE Rule 98(f)(3) would require an approved person or member organization conducting such risk management to: (i) adopt and implement comprehensive written procedures and guidelines governing the conduct of risk management of the specialist unit; (ii) establish a process for regular review of such written procedures and guidelines; and (iii) implement controls and surveillances reasonably designed to prevent and detect violations of these procedures and guidelines.⁶³ These policies and procedures must be reasonably designed to satisfy the requirements in the rule, including that individuals and systems responsible for managing the risk of the specialist unit could not have access to non-public order information, or

⁶² An affiliate of a specialist unit conducting risk management trading pursuant to proposed NYSE Rule 98(f)(3) would not require an exemption from the requirements of NYSE Rule 105(b)-(d) and the Rule 105 Guidelines because, under the proposed changes to NYSE Rule 105, the prohibitions on risk management trading would apply only to the specialist unit itself and not to approved persons. See supra Section III(D)(1).

⁶³ See proposed Rule 98(f)(3)(C).

with certain exceptions, specialist confidential information.⁶⁴ These exceptions are limited to allowing individuals and systems responsible for managing the risk of the specialist unit to have electronic access to the specialist unit's trades once they are printed to the Consolidated Tape.⁶⁵ In addition, an approved person or member organization could electronically direct the specialist unit's trading or quoting, subject to the specialist unit's market making obligations.

The Commission finds that the proposed rule change to permit an approved person or a member organization associated with a specialist unit to conduct its risk management trading related to the specialist unit's trading is consistent with the Act. The Commission believes that the policies and procedures an approved person or member organization would be required to establish and that NYSE Regulation would need to revise would protect specialist confidential information and non-public order information.

The Commission also believes that proposed NYSE Rule 98 would continue to mitigate conflicts of interest between the specialist's responsibilities to the market and the business activities of specialist affiliates. In this regard, the proposed rule would require the specialist unit to determine whether any recommendations provided to it by an "upstairs" risk management desk are consistent with its market making obligations, including Exchange specialist rules. Thus, the Commission expects that the specialist unit would accept or reject such recommendations in a manner that is consistent with its market making obligations.

E. Failure to Maintain Confidentiality, Reporting Obligations, and Breaches

Proposed NYSE Rule 98(g) would provide that, if a specialist becomes aware of non-public material information from its approved person or parent member organization, the specialist may have to cease acting as a specialist temporarily in the security involved. Proposed

⁶⁴ See proposed Rule 98(f)(3)(C)(ii)

⁶⁵ See supra note 54 and accompanying text.

NYSE Rule 98(i) would provide that any breach of the proposed NYSE Rule 98 could result in disciplinary action, including the withdrawal of one or more securities allocated to the specialist unit or withdrawal of approval to operate a specialist unit. Both rules are substantially similar to provisions in current NYSE Rule 98⁶⁶ and the Commission believes they are consistent with the Act.

Paragraphs (1) and (2) of proposed NYSE Rule 98(h) are substantially similar to the current reporting obligations in current NYSE Rule 98.⁶⁷ Proposed NYSE Rule 98(h)(1) would require “after the fact” reporting of information regarding material investment banking activities in which the member organization or approved person has been engaged and material research reports, recommendations, etc. pertaining to any security that has been allocated to the specialist unit. Proposed NYSE Rule 98(h)(2) would require “after the fact” reporting of information about determinations regarding whether the specialist should cease acting as specialist in the event the specialist unit receives non-public information. Paragraphs (3) and (4) of proposed NYSE Rule 98(h) would add a new requirement for specialist units to report any actual breaches, or internal investigations of possible breaches, of the information barriers required by the rule. In particular, a specialist unit would be required to conduct an internal investigation into any trading activity that may be a result of a breach of information barriers required by proposed NYSE Rule 98. In addition, on a quarterly basis, a specialist unit would have to report in writing to NYSE Regulation whether it has commenced such an internal investigation, the quarterly progress of any open investigations, what remedial measures, if any, were taken, and the completion of any internal investigation, including the methodology and results of such

⁶⁶ See current NYSE Rule 98, Guidelines (i) and (k).

⁶⁷ See current NYSE Rule 98, Guidelines (j).

investigation, any internal disciplinary action taken, and any referral of the matter to the NYSE, another self-regulatory organization, or the Commission.⁶⁸

The Commission finds that proposed NYSE Rule 98(h) is consistent with the Act and would provide NYSE Regulation with an additional tool to monitor compliance with NYSE Rule 98. The Commission notes that NYSE designed the reporting obligation for internal investigations in the proposed rule to be effectively similar to the reporting obligation in other NYSE rules.⁶⁹

F. Existing Specialists

1. NYSE Rule 98 (Former)

Because a current specialist may decide to keep its current operational structure or delay implementation of a new operational structure, the NYSE proposes to retain current NYSE Rule 98 but limit its applicability to specialist organizations and their associated approved persons operating as of the date of this Order. Specifically, current NYSE Rule 98 would be re-designated as “Rule 98 (Former)” in the NYSE Rules until all specialist units are approved for operation pursuant to the proposed rule.⁷⁰ Except for the sharing of non-trading related services, as discussed below, such member organization and its approved persons would continue to be subject to NYSE Rule 98 (Former) as well as the “(Former)” versions of NYSE Rules that reference exemptions from Rule 98 (Former) for approved persons. Any new specialist units would be required to comply with proposed NYSE Rule 98. Any significant changes to the

⁶⁸ See proposed NYSE Rule 98(h)(4).

⁶⁹ See NYSE Rules 351(e) and 342.21

⁷⁰ See proposed NYSE Rule 98 (Former).

status quo after the effective date of the proposed rule would require the member organization to apply for approval pursuant to the procedures of proposed NYSE Rule 98.⁷¹

The Commission finds that the NYSE's proposal to continue to permit current specialist units to operate under current NYSE Rule 98, redesignated as NYSE Rule 98 (Former), is consistent with the Act. Allowing specialist units to continue to operate under current NYSE Rule 98 would provide specialist units time to develop or modify their policies and procedures and avoid any unnecessary disruption in their businesses.

2. Sharing of Non-Trading Related Services

The proposed rule change would provide that a member organization operating pursuant to NYSE Rule 98 (Former) could apply for approval from NYSE Regulation to share non-trading related services.⁷² Any such sharing of non-trading related services would be pursuant to proposed NYSE Rule 98(e).⁷³

The Commission finds that the NYSE proposal to permit specialist units operating under NYSE Rule 98 (Former) to seek approval under proposed NYSE Rule 98 to share non-trading related services is consistent with the Act. Specialist units operating under NYSE Rule 98 (Former) and their approved persons would be required to maintain informational barriers prescribed by the current NYSE Rule 98 Guidelines. The Commission believes that those Guidelines, combined with the requirements under proposed NYSE Rule 98(e) regarding the sharing of non-trading related services would protect against the misuse of non-public information.

⁷¹ See Notice, supra note 3, at 73 FR at 38276.

⁷² See NYSE Rule 98 (Former), Guidelines(c).

⁷³ See supra notes 41 - 42 and accompanying text for a discussion of these rules.

G. Additional Rule Changes

As described above, under the proposed rule, instead of reviewing whether to grant each approved person an exemption from NYSE Rule 98, NYSE Regulation would review the specialist unit's policies, procedures, controls, and surveillance. For this reason, the NYSE proposes to amend the NYSE rules that refer to approved persons and to the need for an exemption from NYSE Rule 98.

1. Proposed Amendments to NYSE Rule 98A

NYSE Rule 98A currently requires approved persons to agree in writing not to cause a specialist or odd-lot dealer to violate rules applicable to the specialist or odd-lot dealer. The rule further requires that approved persons report to the Exchange any off-Floor orders for securities in which an associated specialist member organization specializes for any account in which the approved person has a direct or indirect interest.

Under the proposed amendments to NYSE Rule 98A, approved persons would no longer be required to agree in writing not to cause a specialist or odd-lot dealer to violate rules applicable to the specialist or odd-lot dealer. Approved persons also would no longer be required to report any off-Floor orders for securities in which an associated specialist member organization specializes for any account in which the approved person has a direct or indirect interest to the Exchange. The Commission believes that the elimination of these requirements is consistent with the Act because, under proposed NYSE Rule 98, the specialist unit would be walled-off from approved persons.

2. Proposed Amendments to NYSE Rules 99, 102, 103B, 104, and 113

NYSE Rules 99, 103B, 104, and 113 currently specifically apply to approved persons, unless such approved person has obtained an exemption under Rule 98. Under the proposed rule

change, current NYSE Rules 99, 103B, 104, and 113 would be amended to remove references to approved persons.⁷⁴ The Commission believes that the elimination of the references to approved persons in these rules is consistent with the Act because, under proposed NYSE Rule 98, the specialist unit would be walled-off from approved persons.

NYSE Rule 102 currently governs trading in related products by an odd-lot dealer. The Commission believes that the deletion of current NYSE Rule 102 is consistent with the Act. The Commission notes that the Exchange no longer has separate odd-lot dealers and all specialists are also responsible for odd-lot trading in securities in which they are registered. The Commission also notes that specialists would be subject to the standards set forth in proposed Rules NYSE 98 and 105.

3. Proposed Amendments to NYSE Rule 460

Current NYSE Rule 460.10 prohibits a specialist, its member organization or approved person (or officer or employee thereof) from, individually or in the aggregate, owning more than 10% of the outstanding shares of any equity security in which the specialist is registered.⁷⁵ Current NYSE Rule 460.10 also requires such person to report to the NYSE when it, directly or indirectly, acquires more than 5% of the outstanding shares of such equity security and promptly dispose or reduce such interest if advised to do so by the Exchange. A specialist, its member organization or approved person (or officer or employee thereof) may exceed the 10% ownership

⁷⁴ For the period of time that the current NYSE Rule 98 stays in the NYSE Rules as “NYSE Rule 98 (Former),” each of NYSE Rules 99, 103B, 104, and 113 will have two forms: one to meet the requirements of NYSE Rule 98 (Former) and one to meet the requirements of proposed NYSE Rule 98. The version of the rules that relate to NYSE Rule 98 (Former) will be similarly designated with the “(Former)” title either for the entire rule, or for a section of a rule, as appropriate.

⁷⁵ The prohibitions in current NYSE Rule 460.10 do not apply if the security is a convertible security, American Depositary Receipt, Global Depositary Receipt or exchange-traded funds tied to the equity securities, current or index warrants.

threshold for derivative securities whose values are based on an underlying currency or index only with the approval of the NYSE; however, in no event may such person directly or indirectly own more than 25% of such derivative securities.

The proposed amendments to NYSE Rule 460 would make changes so that it would apply only to the specialist member and his specialist unit and not to his member organization or approved persons. In addition, the proposed amendments would replace the 10% ownership limitation set forth in NYSE Rule 460.10 with a requirement that the specialist unit report to the Exchange the beneficial ownership of more than 5% of an equity security that is allocated to it. The specialist unit would be required to update such reports if its beneficial ownership exceeds 10% or falls below 5%. In addition, the specialist unit would be prohibited from acquiring, directly or indirectly, more than 25% of the outstanding shares in any security allocated to the specialist unit.⁷⁶ The proposed amendments to NYSE Rule 460 would apply to specialist units operating under proposed NYSE Rule 98, as well as to specialist member organizations that continue to operate under NYSE Rule 98 (Former).

The Commission believes that the proposed changes to NYSE Rule 460.10 are consistent with the Act. Consistent with the NYSE's proposed changes to Rule 98, the changes to Rule 460 would apply the restrictions in the rule only to the specialist. The Commission believes that, because of the policies and procedures a specialist unit or any integrated proprietary aggregation unit in which it is a part would be required to implement, these changes to Rule 460 are consistent with the Act. Further, the Commission believes that, because of the increased competition among markets in NYSE listed securities, the elimination of the restrictions in Rule 460.10 are consistent with the Act.

⁷⁶ See Amendment No. 1, supra note 4.

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NYSE-2008-45), as modified by Amendment No. 1, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁷⁷

Florence E. Harmon
Acting Secretary

⁷⁷ 17 CFR 200.30-3(a)(12).