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For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-56711; File No. SR-NYSE-2007-83]

### Self-Regulatory Organizations; New York Stock Exchange LLC; Order Granting Approval of Proposed Rule Change Relating to NYSE Rule 104.10 (“Dealings by Specialists”)

October 26, 2007.

On September 14, 2007, the New York Stock Exchange LLC (“NYSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to (i) extend the duration of its pilot program applicable to “Conditional Transactions” as defined in NYSE Rule 104.10 (“Dealings by Specialists”) to March 31, 2008<sup>3</sup>; (ii) remove the “active securities”<sup>4</sup> limitation on Conditional

Transactions that establish or increase a specialist’s position and reach across the market to transact with the NYSE’s published quote; and (iii) make certain conforming changes to NYSE Rule 104.10(5). The proposed rule change was published for comment in the **Federal Register** on September 25, 2007.<sup>5</sup> The Commission received no comments on the proposal. This order approves the proposed rule change.

#### I. Description of the Proposal

NYSE Rule 104 governs specialist dealings and includes, among other things, restrictions upon specialists’ ability to trade as dealer in the stocks in which he or she is registered. Under NYSE Rule 104(a), specialists are not permitted to effect transactions on the Exchange for their proprietary accounts in any security in which the specialist is registered, “unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market \* \* \*.” This restriction is known as the “negative obligation.” In particular, NYSE Rules 104.10(5) and (6) expand upon the negative obligation with respect to specific types of proprietary transactions.

In December 2006, as part of extensive amendments to its specialist stabilization rules, the Exchange implemented a pilot program allowing specialists to execute transactions in active securities that establish or increase a position and reach across the market to trade as the contra-side to the Exchange published bid or offer (Conditional Transactions) without restriction as to price or Floor Official approval, provided that the specialist appropriately re-enters on the opposite side of the market in a size commensurate with the specialist’s Conditional Transaction.<sup>6</sup> NYSE issued guidelines called “Price Participation Points” (“PPPs”) that identify the price at or before which a specialist is expected to re-enter the market after effecting one or more Conditional Transactions. PPPs are minimum guidelines only and compliance with them does not guarantee that a specialist is meeting its obligations. Under the pilot program, certain Conditional

Transactions require the specialist to immediately re-enter, or re-enter as the specialist’s next available quoting or trading action, regardless of the PPP.<sup>7</sup> For example, immediate re-entry may be required based on the price and/or volume of the specialist’s Conditional Transaction(s) in reference to the market in the security at the time of such trading. The fact that there may have been one or more independent trades following the specialist’s Conditional Transaction does not, by itself, eliminate the need for immediate re-entry when otherwise appropriate. In addition, immediate re-entry is required after a Conditional Transaction: (a) Of 10,000 shares or more or a quantity of stock with a market value of \$200,000 or more; and (b) which exceeds 50% of the published bid or offer size (as relevant).<sup>8</sup>

Specialists currently are not permitted to establish or increase a position in “inactive securities”<sup>9</sup> by reaching across the market to purchase the offer at a price that is above the last sale price on the Exchange or sell to the bid at a price that below the last sale price on the Exchange, unless such specialist trade is reasonably necessary to render the specialist’s position adequate to the immediate and reasonably anticipated needs of the market and approved by a Floor Official. Further, for inactive securities, specialists currently are not permitted to purchase more than 50% of the stock offered at a price that is equal to the last sale price when the last sale price was higher than the last differently priced regular way sale, unless such trade is approved by a Floor Official. Specialists must re-enter the market when reasonably necessary after effecting such trades.<sup>10</sup>

The Exchange is now proposing to extend its pilot program applicable to Conditional Transactions to March 31, 2008 and remove the “active securities” restriction included in the pilot, enabling specialists to execute Conditional Transactions in all securities traded on the NYSE.<sup>11</sup> The Exchange will continue to apply its PPP guidelines, and specialists will continue to be required to meet the re-entry obligations of NYSE Rule 104.10(6). In

<sup>15</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> A “Conditional Transaction” is defined as a specialist transaction in an active security that establishes or increases a position and reaches across the market to trade as the contra-side to the Exchange published bid or offer. See NYSE Rule 104.10(6)(ii) (which is renumbered pursuant to this proposal as NYSE Rule 106.10(6)(i)).

<sup>4</sup> Original NYSE Rule 104.10(6)(i) defines “active securities” as: (a) Securities comprising the S&P 500 Index; (b) securities traded on the Exchange during the first five trading days following their initial public offering; and (c) securities that have been designated as “active” by a Floor Official pursuant to the parameters set forth in the rule. In general, a governing Floor Official may designate a security as “active” by determining, among other things, that the security in question has exhibited substantially greater than normal trading volume and is likely to continue to sustain such higher volume during the remainder of the trading session.

<sup>5</sup> See Securities Exchange Act Release No. 56455 (September 18, 2007), 72 FR 54499 (“Notice”).

<sup>6</sup> See Securities Exchange Act Release No. 54860 (December 1, 2006), 71 FR 71221 (December 8, 2006) (SR-NYSE-2006-76). The operation of the pilot was subsequently extended two times, first until September 30, 2007 and then until the earlier of (i) December 31, 2007 or (ii) the approval by the Commission of this proposed rule change. See Securities Exchange Act Release Nos. 55995 (June 29, 2007), 72 FR 37288 (July 9, 2007) (SR-NYSE-2007-58); and 56554 (September 27, 2007), 72 FR 56419 (October 3, 2007) (SR-NYSE-2007-84).

<sup>7</sup> See NYSE Rule 106.10(6)(iv) (which is renumbered pursuant to the proposal as NYSE Rule 106.10(6)(iii)).

<sup>8</sup> See NYSE Rule 106.10(6)(iv)(c)(I) and (II) (which are renumbered pursuant to the proposal as NYSE Rule 106.10(6)(iii)(c)(I) and (II)).

<sup>9</sup> “Inactive securities” are securities that do not fall within NYSE’s definition of active securities. See *supra* note 4.

<sup>10</sup> See NYSE Rule 106.10(5)(b)(I).

<sup>11</sup> During the pilot, the restrictions currently in effect for inactive securities pursuant to NYSE Rule 106.10(5)(b) will be suspended.

addition, specialists will continue to be subject to their negative obligation.

## II. Discussion and Commission Findings

After careful consideration, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>12</sup> and, in particular, the requirements of Section 6 of the Act.<sup>13</sup> Specifically, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>14</sup> which requires, among other things, that the rules of a national securities exchange be designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, and 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. Finally, the Commission believes the proposal is consistent with the principles set forth in Section 11A of the Act<sup>15</sup> and the requirements of Rule 11b-1 under the Act.<sup>16</sup>

Specialists' dealer activities are governed, in part, by the negative and affirmative trading obligations. Rule 11b-1 under the Act requires exchanges that permit members to register as specialists to have rules governing specialists' dealer transactions so that their proprietary trades conform to the negative and affirmative obligations. The negative obligations as set forth in Rule 11b-1 under the Act require that a specialist's dealings be restricted, so far as practicable, to those reasonably necessary to permit a fair and orderly market.<sup>17</sup> The affirmative obligation as set forth in Rule 11b-1 under the Act requires a specialist to engage in a course of dealings for its own account to assist in the maintenance, so far as practicable, of a fair and orderly market.<sup>18</sup> NYSE has adopted these obligations in its Rule 104, which includes restrictions on when

specialists may effect certain transactions.

In connection with the Commission's approval of amendments to the Exchange's stabilization rules, including the implementation of Exchange's current pilot program for Conditional Transactions, the Commission eliminated the trade-by-trade standard previously applied to specialist trades for the purpose of determining whether such trade was "reasonably necessary" in accordance with the negative obligation.<sup>19</sup> The Commission noted that increased automation and competition—both within the Hybrid Market and in the markets generally—are significant factors, among others, that affect the ability of specialists to make trade-by-trade analysis regarding their negative obligation, and found that permitting specialists to consider the reasonable necessity of their transactions under negative obligations without a transaction-by-transaction test was appropriate and consistent with the Act. The Commission emphasized, however, that specialists must continue to comply with the negative obligation, and assess their need to trade and limit their proprietary trades to those reasonably necessary to allow the specialists to maintain a fair and orderly market.<sup>20</sup>

NYSE is now proposing to (i) extend the duration of its pilot program applicable to Conditional Transactions to March 31, 2008; (ii) remove the "active securities" limitation on Conditional Transactions that establish or increase a specialist's position and reach across the market to transact with the NYSE's published quote; and (iii) make certain conforming changes to NYSE Rule 104.10(5). NYSE specialists would remain subject to the negative obligation and would be required to

appropriately re-enter the market after a Conditional Transaction is executed and, for certain Conditional Transactions, the specialist must re-enter immediately following the trade. In addition, the Exchange's PPP guidelines would continue to apply.

NYSE believes that the specialists are critical to its market structure, and that they perform an important function in the marketplace. Specifically, NYSE believes that, by committing capital, specialists provide market depth, lower market volatility, and reduce overall execution costs for investors. NYSE also believes that specialists bridge gaps between supply and demand, and help to maintain a fair and orderly market. Furthermore, the Exchange believes that advances in technology have virtually obviated the specialists' time and place advantage, and states that the rate of trading participation by specialists in specialist stocks has been significantly reduced. As a result, the Exchange believes that the basis for concern over specialist conflicts of interest (and the consequent ability of specialists to trade to the detriment of the public) is also diminished. NYSE highlights that the proposal does not in any way reduce the obligations imposed on its specialists pursuant to NYSE Rule 104 to re-enter a transaction on the opposite side of the market or alter their negative obligation. The Exchange believes that these factors support their proposal to extend the ability of the specialist to effect Conditional Transactions to all securities, and that providing specialists such ability would allow them to more effectively meet their affirmative and negative obligations by giving them the tools to better manage the inventory of their account.<sup>21</sup>

NYSE has committed to provide the Commission with statistics related to market quality, specialist trading activity, and sample statistics on an ongoing monthly basis.<sup>22</sup> The

<sup>12</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>13</sup> 15 U.S.C. 78f.

<sup>14</sup> 15 U.S.C. 78f(b)(5).

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

<sup>16</sup> 17 CFR 240.11b-1.

<sup>17</sup> 17 CFR 240.11b-1(a)(2)(iii).

<sup>18</sup> 17 CFR 240.11b-1(a)(2)(ii).

<sup>19</sup> See Securities Exchange Act Release No. 54860, *supra* note 6, at 71228. Previously, specialists were required to comply with the negative obligation on a transaction-by-transaction basis pursuant to a 1937 Commission interpretation known as the "Saperstein Interpretation." See Securities Exchange Act Release No. 1117, 1937 SEC LEXIS 357 (March 30, 1937). See also Securities Exchange Act Release No. 54860, *supra* note 6, at 71227 for a discussion of the Saperstein Interpretation. Specifically, in the Saperstein Interpretation, the Commission stated that the negative obligation "prohibits all transactions for the account of a specialist, excepting only such transactions as are properly a part of a course of dealings reasonably necessary to permit the specialist to maintain a fair and orderly market \* \* \*." Further, the interpretation stated that *each transaction* by a specialist for its own account must meet the test of reasonable necessity, making clear that a specialist must comply with the rule on a transaction-by-transaction basis. See Securities Exchange Act Release No. 1117, *supra*, at 3-4.

<sup>20</sup> See Securities Exchange Act Release No. 54860, *supra* note 6, at 71228.

<sup>21</sup> In addition, the Exchange provided data which it contends evidences that the original stabilization pilot had no discernable adverse impact on liquidity or market quality. See Securities Exchange Act Release No. 56455, *supra* note 5 at 54501-2. See also Appendices 3A, 3B, and 3C, which are available at the Commission's Web site at <http://www.sec.gov/rules/sro/nyse/2007/34-56455appendix3.pdf>.

<sup>22</sup> Specifically, the Exchange has agreed to provide sample statistics, including the daily Consolidated Tape volume in shares, daily number of trades, daily high-low volatility in basis points, and daily close price in dollars. In addition, the Exchange will calculate the specialist profit on round-trip Hit Bid and Take Offer ("HB/TO") executions, by measuring the specialist profit on HB/TO activity by taking the round-trip trading profits for all HB/TO trades where the specialist executes an offsetting trade within 30 seconds. In cases where the volume of the offsetting execution

Commission believes that this data will be important in helping it analyze the impact of this proposed rule change, and in determining whether to extend the operation of this rule or to approve this rule on a permanent basis.

The Commission continues to believe that the provisions governing Conditional Transactions may reflect an appropriate balance between the needs of specialists and other market participants in today's fast moving markets.<sup>23</sup> The Commission notes that specialists continue to be subject to the negative obligation, which requires that their proprietary trading be limited to that reasonably necessary to maintain a fair and orderly market. In approving the expansion of the pilot program beyond active securities, the Commission continues to recognize the potential conflicts of interest presented when a specialist engages in aggressive trading activity such as reaching across the market to trade with the NYSE bid or offer while increasing its position, particularly in the case of less liquid securities. Also, the proposed rule change represents a further shift in the role and obligations of specialists at the Exchange. As such, the Commission is approving the proposed expansion of the scope of the pilot, enabling specialists to execute Conditional Transactions in all securities traded on the NYSE, and the proposed extension of the duration of the pilot until March 31, 2008.

The Commission emphasizes that the extension of the pilot to all securities in no way relieves specialists of their obligations under federal securities laws or NYSE rules. A specialist's ability to effect proprietary transactions remains

is less than the size of the HB/TO execution, the calculation will only include profits realized within the 30-second window. The Exchange will further calculate the quote-based specialist re-entry ratio, and each re-entry price level will be categorized and reported separately. The categories will be in cent intervals at 0, 1, 2, 3, 4, and 5 or more cents. The time window for these calculations will also be in 30 seconds. Finally, the Exchange has agreed to provide the Commission with data related to the average realized spread on specialist HB/TO executions using the formula set forth in Rule 605 of Regulation NMS under the Act. 17 CFR 242.605. Specifically, the average realized spread should be a share-weighted average of realized spreads. For specialist buys, the spread will be double the amount of the difference between the execution price and the midpoint of the consolidated best bid and offer five minutes after the time of HB/TO execution. For specialist sells, the spread will be double the amount of the difference between the midpoint of the consolidated best bid and offer five minutes after the time of HB/TO execution and the execution price. The Exchange has also committed to maintain average measures for each stock-day during a particular month in order to provide such information to the Commission upon request.

<sup>23</sup> See Securities Exchange Act Release No. 54860, *supra* note 6, at 71229.

limited under the Act and the Exchange's rules and specialists must still determine whether their transactions are reasonably necessary. The Commission notes that the Exchange is obligated to surveil its specialists to ensure their compliance with the Act and NYSE rules, and the Exchange has stated that NYSE Regulation believes that it has appropriate surveillance procedures in place to surveil for compliance with the negative obligations.

For the reasons discussed above, the Commission finds that the proposed rule change is consistent with the Act.

#### IV. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>24</sup> that the proposed rule change (SR-NYSE-2007-83), be and hereby is, approved on a temporary basis until March 31, 2008.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>25</sup>

**Florence E. Harmon,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-56718; File No. SR-NYSE-2007-95]

### Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Rule 18 (Compensation in Relation to Exchange System Failure)

October 29, 2007.

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 12, 2007, the New York Stock Exchange LLC ("NYSE" or the "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been substantially prepared by the Exchange. The NYSE filed the proposal pursuant to Section 19(b)(3)(A) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder,<sup>4</sup> which renders it effective upon filing with the Commission. The Commission is publishing this notice to solicit

<sup>24</sup> 15 U.S.C. 78s(b)(2).

<sup>25</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> 15 U.S.C. 78s(b)(3)(A).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

comments on the proposed rule change from interested persons.

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

The Exchange is proposing to amend Exchange Rule 18 to reduce the dollar amount required in order for a member organization to seek compensation in the event of an Exchange System failure. The Exchange is further seeking to make technical amendments to the rule text.

#### 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 Exchange 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 IV below. The Exchange 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

Through this filing, the NYSE seeks to amend Exchange Rule 18 to reduce the dollar amount required for a member organization to seek compensation in the event of an Exchange system failure. Pursuant to the proposal, the Exchange seeks to reduce the current requirement that a net loss be in the amount of \$5,000 or higher in order for a member organization to be eligible to make a claim for compensation. Rather, the Exchange seeks to lower the net loss requirement to \$500.

##### Current Exchange Rule 18 (Compensation in Relation to Exchange System Failure)

Today, Exchange Rule 18 sets forth that member organizations that sustain a loss in relation to an Exchange system failure<sup>5</sup> are eligible to submit a claim for compensation to the Exchange, if certain requirements are met. Pursuant to the current rule, in order for a member organization to be eligible to receive payment for a claim, it must incur a net loss equal to or greater than \$5,000. That is, the loss must total

<sup>5</sup> An Exchange system failure is defined as a malfunction of the Exchange's physical equipment, devices and/or programming which results in an incorrect execution of an order or no execution of an order that was received in Exchange systems. See Exchange Rule 18(b).