Exchange's Specialist Combination Review Policy (the "Policy") which would require proponents of certain specialist unit combinations to address issues related to the capitalization, risk management, and operational efficiency of large sized specialist units.

## 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 self-regulatory organization 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 self-regulatory organization 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 purpose of the proposed rule change is to provide uniformity to the Quality of Markets Committee's consideration of combinations of specialist units with respect to matters of capitalization, risk management, and operational efficiency.

The Policy requires Exchange approval of proposed specialist unit combinations exceeding five percent of any one of four concentration measures.1 In any instance where a proposed combination will result in a specialist unit accounting for more than five percent of any concentration measure, the Exchange's Quality of Markets Committee (the "Committee") is required to conduct a review of the proposed combination. This review includes an analysis of specialist performance and market quality in the stocks subject to the proposed combination. The Committee looks at the effects of the proposed combination in terms of strengthening the capital base of the new unit, minimizing the potential for financial failure of the new unit and maintaining or increasing operational efficiencies within the resulting specialist organization. The

- $^{\rm 1}\, {\rm The}$  measures include specialist share of:
- Allocation for all listed common stocks
- Allocation for the 250 most active listed common stocks
- Total share volume of stock trading on the Exchange
- Total dollar value of stock trading on the Exchange.

Committee also considers the proposed unit's commitment to the Exchange market and the effect of the proposed combination on overall concentration of specialist organizations.

Where a proposed combination would result in a specialist unit which accounts for more than ten percent of a concentration measure, the primary consideration during the Committee's review is the effect of the proposed combination on overall concentration of specialist units. If the new unit accounts for more than ten percent, but less than or equal to 15%, of a concentration measure, the Policy requires the proponents of the combination to prove, by a preponderance of the evidence, that the proposed combination:

(i) would not cause detrimental concentration, in the specialist business, to the Exchange and its markets;

(ii) would foster competition among specialist units; and

(iii) would enhance the performance of the constituent specialist unit and the quality of the markets in the stocks involved.

The Policy also requires the proponents of any combination greater than ten percent, but less than 15%, to prove, by a preponderance of the evidence, that the proposed combination, if approved, is otherwise in the public's interest.

Where the proposed combination would result in a specialist unit which accounts for greater than 15% of a concentration measure, the Policy requires the proponents of the combination to provide clear and convincing evidence of the factors stated in (i) through (iii) above. The proponents of the combination would also be required to provide clear and convincing evidence that the proposed combination is otherwise in the public's interest.

The Exchange is proposing to amend the Policy to add several requirements which address issues related to the capitalization, risk management, and operational efficiency of large sized specialist units. The proposed rule changes require proponents of a combination that would exceed 10% of a concentration measure to:

- Submit an acceptable risk management plan with respect to any line of business in which they engage;
- Submit an operational certification prepared by an independent, nationally recognized management consulting organization with respect to all aspects of the firm's management and operations;
- Agree to maintain a minimum of 1.5 times (2 times, in the case of a 15% combination) the total capital

requirement specified in Rule  $104.20^{\,2}$  with respect to the combined entity's stocks;

- Agree to maintain 2 times (2.5 times, in the case of a 15% combination) the capital requirement specified in Rule 104.20 with respect to each of the combined entity's stocks that are component stocks of the Standard and Poor's 500 Stock Price Index; and
- Agree that all capital required to be dedicated to specialist operations be accounted for separate and apart from any other capital of the combined entity, and that such specialist capital may not be used for any other aspect of the combined entity's operations.

The Exchange is also proposing to require that proponents of a proposed combination that would result in a specialist unit accounting for more than five percent, but less than or equal to 10%, of a concentration measure, maintain 1.5 times the capital requirement specified in Rule 104.20 with respect to each of the combined entity's stocks that are components stocks of the Standard and Poor's 500 Stock Price Index.

The Exchange believes that these new requirements are appropriate in that the requirements are intended to minimize the risk of financial and/or operational failure of larger-sized units, and to ensure that such units have sufficient, separately dedicated capital with which to meet their market making responsibilities.

## 2. Statutory Basis

The basis under the Securities Exchange Act of 1934 (the "Act") for this proposed rule change is the requirement under Section 6(b)(5) that an Exchange have rules that are 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 market system and, in general, to protect investors and the public interest. The proposed amendments are consistent with these objectives in that they address concerns about capitalization, operational efficiency, and risk management where proposed combinations would result in large sized specialist units.

## B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose

<sup>&</sup>lt;sup>2</sup> NYSE Rule 104.20 lists the capital requirements of specialist units with respect to the requisite: position of trading units it is capable of assuming for various forms of securities; net liquid assets; and minimum capital requirement it is capable of meeting with its own net liquid assets.