(B) Self-Regulatory Organization's Statement on Burden on Competition

The Amex believes that the proposed rule change will impose no burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments on the proposed rule change were neither solicited nor received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the proposed rule change establishes a due, fee, or other charge imposed by the Exchange, it has become effective pursuant to Section 19(b)(3)(A) of the Act and subparagraph (e) of Rule 19b–4 thereunder. At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. 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 Section, 450 Fifth Street, NW., Washington, DC. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to File No. SR–Amex–96–09 and should be submitted by April 26, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[3]

[3] 17 CFR 200.30–3(a)(12) (1994).

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–8395 Filed 4–4–96; 8:45 am]

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[Release No. 34–37045; File No. SR–BSE–95–02]

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Order Granting Approval of Proposed Rule Change Permitting Competing Specialists on the Floor of the Exchange

March 29, 1996.

I. Introduction

On February 6, 1995, the Boston Stock Exchange, Inc. (''BSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''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 adopt permanently rules permitting competing specialists on the floor of the Exchange and guidelines governing their registration and activity. The proposed rule change was published for comment in Securities Exchange Act Release No. 35404 (February 22, 1995), 60 FR 10882 (February 28, 1995).[3] Four comment letters were received on the proposed rule change.

II. Background

On May 18, 1994, the Commission approved a one-year pilot program, referred to as the Competing Specialist Initiative (''CSI''), that permits competing specialists on the floor of the BSE.[4] The pilot has been extended twice and will expire after March 29, 1996.[5]

Initially, the CSI pilot limited the number of specialists that could compete in a stock to three—one regular specialist and up to two Competing Specialists. Each Competing Specialist was limited to 10 stocks, unless the Exchange's Market Performance Committee approved an increase of up to 20 stocks per applicant firm. Competing Specialists were also prohibited from making cash payments for order flow. In its most recent extension of the program, the Commission approved an expansion of the program to allow a total of four specialists per stock. In addition, Competing Specialists were permitted to trade up to 100 stocks each. Presently, there are four member firms participating in the pilot program, cumulatively making markets in 44 stocks (''CSI stocks''). The Exchange proposes that the CSI be permanently approved without the above restrictions.

III. Description of the Program

As explained further below, the principal feature of the CSI is that it permits members to route order flow to a designated specialist for execution. Such order flow would only be executed by the designated specialist if there are then no limit orders on the BSE book at the execution price and one of the other specialists are quoting at the ITS/BBO with time priority.

A. Mechanics of the Competing Specialist Program

Under the BSE's competing specialist pilot, the Exchange's rules governing the auction market principles of priority, parity, and precedence remain unchanged for quotes at the Intermarket Trading System (''ITS'') best bid or offer (''BBO'').[6] Quotes representing customer orders have priority over specialists' quote at the same price,[7] and specialist quoting at the ITZ/BBO have priority over specialists not quoting at the ITS/BBO. If two or more specialists are quoting at the ITS/BBO, the earliest bid/offer at that price has time priority and will be filled first up to its specified size.[8] If the specialists are on both price

[1] 15 U.S.C. § 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] On August 10, 1995, the BSE submitted Amendment No. 1 to the proposed rule change. Amendment No. 1 clarified that, under the BSE rules, limit orders will be executed in the order in which they are received by the BEACON System, *i.e.*, according to strict time priority, irrespective of firm order routing procedures. The rule change contained in Amendment No. 1 has been approved as part of the most recent extension of the competing specialist pilot. *See* Securities Exchange Act Release No. 36323 (September 29, 1995), 60 FR 52440 (October 6, 1995) (order extending pilot through March 29, 1996).

[4] *See* Securities Exchange Act Release No. 34078 (May 18, 1994), 59 FR 27082 (May 25, 1994) (''Pilot Approval Order''). Competition between multiple specialists on the Exchange did not begin, however, until July 1994, when two firms began acting as Competing Specialists in a total of seven issues.

[5] *See* Securities Exchange Act Release No. 35716 (May 15, 1995), 60 FR 26908 (May 19, 1995) (order extending pilot through October 2, 1995); and Securities Exchange Act Release No. 36323, *supra* note 3 (order extending pilot through March 29, 1996).

[6] *See* BSE Rules, Chapter II, Sec. 6.

[7] When acting as an agent, specialists are required to hold the interests of orders entrusted to them above their own interests. *See* BSE Rules Chapter XV, Sec. 2(b). Specialists may not trade for their own accounts at the same or better price as unexecuted limit orders that are being held for customers. *See* BSE Rules, Chapter II, Sec. 11. The Exchange recently clarified in its rules that because there is only one Exchange market in a security, specialists may not trade ahead of any limit order on the Exchange, irrespective of firm order routing designations. *See* Securities Exchange Act Release No. 36323, *supra* note 3.

[8] Regardless of the number of specialists competing in a stock, the BSE displays only one consolidated quotation (best quote among all the

and time parity at the ITZ/BBO, all bids/offers equal to or greater than the size of the contra-side order are on parity and entitled to precedence over smaller orders.

All limit orders sent to the BSE must be entered into the BSE's automated order routing system (''BEACON''), which maintains one consolidated limit order book for the Exchange and ensures that limit orders at the same price are kept in strict time priority, irrespective of routing designations. Each specialist in a security has the ability to execute limit orders on the Exchange's consolidated limit order book through its BEACON terminal. Market orders and marketable limit orders routed through BEACON (approximately 95% of all orders on the BSE) [9] are automatically executed by the system against any contra-side orders on the consolidated limit order book. Before any market and marketable limit orders are automatically executed by the BEACON system, however, they are exposed to the designated specialist for 15 seconds to give that specialist an opportunity to improve the price.[10]

Under CSI rules, when there are no customer limit orders at the ITS/BBO and none of the other specialists in the stock are quoting at the ITS/BBO with time priority, orders may be executed at the ITS/BBO or better by the designated specialist.[11] Orders not directed to a particular specialist are automatically routed to the regular specialist for execution,[12] except that the orders of a routing firm that is affiliated with a Competing Specialist are deemed to be designated to that member firm's affiliated specialist. This prevents member firms affiliated with a specialist from routing non-profitable orders to a non-affiliated specialist when market conditions are unfavorable.[13]

Currently, a Competing Specialist is not able to enter quotes directly into BEACON but must manually communicate its quotes to the regular specialist who then enters the quotes into BEACON on its behalf. Because all quotes are entered into the system by the regular specialist, BEACON presently routes orders that are not executed against the consolidated limit order book to the designated specialist without systematically determining whether another specialist may have a priority quote at the ITS/BBO.[14] In order to encourage competitive quoting by all specialists making markets in a security, the BSE has committed to modify BEACON so that the system will accept quotes directly from Competing Specialists.[15] Once the system is enhanced so that BEACON accepts quotes from each specialist directly, the BSE will reprogram BEACON to route incoming orders to the specialist with priority on the Exchange at the ITS/BBO, or if no such priority has been established, to the designated specialist.[16]

B. Procedures for Competing Specialists

Under the CSI pilot, Competing Specialists have the same affirmative and negative market making obligations as regular specialists [17] and must conform to all other specialist performance requirements and standards set forth in the Rules of the Exchange,[18] including minimum capital and equity requirements.[19]

To register as a Competing Specialist, an applicant must submit a written application to the BSE's Market Performance Committee (''MPC''), listing in order of preference the stock(s) in which the applicant wishes to compete. Applicants for participation in the CSI must be registered with the Exchange as specialists. The MPC reviews applications [20] with consideration for the following factors:

- Overall performance evaluation results of the applicant;
- Financial capability;
- Adequacy of manpower on the floor; and
- Objection by the regular specialist in a stock, with or without cause.[21]

A Competing Specialist seeking to terminate such status must notify the MPC at least three business days prior to the desired effective date of such withdrawal from competition. Withdrawal from registration by a Competing Specialist bars that Competing Specialist from applying to compete in that same stock for 90 days following the effective date of withdrawal. When the regular specialist requests to be relieved of a stock, the stock is posted for reallocation by the Stock Allocation Committee. In the interim, if the MPC is satisfied that the Competing Specialist can continue to maintain a fair and orderly market in such stock, the Competing Specialist will serve as the regular specialist until the stock has been reallocated.[22] Where there is more than one Competing Specialist in the stock, Enchange staff will place the stock with a caretaker[23] until reallocation.

The registration of a Competing Specialist, as is the case with regular specialists, may be suspended or terminated by the MPC upon a determination of any substantial or continued failure by such Competing Specialist to engage in dealings in accordance with the Constitution and Rules of the Exchange.

IV. Summary of Comments

The Commission received four comment letters on the proposed rule change. Paula Gavin, Chairwoman of the NYSE Individual Investors Advisory Council, submitted two letters asserting that ''preferencing'' programs (*i.e.*,

specialists) to other markets in the national market system at all times.

[9] Orders communicated to a specialist (rather than routed to the specialist through BEACON) are entered into BEACON by the specialist for execution.

[10] *See* BSE Rules, Chapter XXXIII, Sec. 3(c).

[11] For example, assume that the ITS/BBO is 20 bid to 20⅛ offered, and specialist A is bidding 19¾ while specialist B is bidding 19½. A market order to sell may be directed to specialist B for execution even though specialist A has a better bid because neither specialist is bidding at the ITS/BBO. Under the competing specialist program, specialist B would execute the order at 20 (the ITS best bid) or better. If specialist A had been bidding 20 (the ITS best bid), specialist A would have had priority to execute the order even though it was directed to specialist B.

[12] *See infra* notes 14 and 15, and accompanying text.

[13] *See infra* notes 14 and 15, and accompanying text.

[14] The Commission notes that, although the BSE's system currently is not able to automatically route orders to the specialist with priority, the BSE's rules on competing specialists do not permit a specialist to trade through another BSE specialist's quote that has priority at the ITS/BBO. If this were to occur, it would be a violation of BSE rules. The Commission expects the BSE to take appropriate regulatory action in the event of such a violation of the CSI rules.

[15] *See* letter from John I. Fitzgerald, Executive Vice President, BSE, to Howard Kramer, Associate Director, SEC, dated February 29, 1996 (agreeing to complete system enhancements within one year from permanent approval of the CSI).

[16] *Id.*

[17] *See, e.g.,* U.S.C. 78k; and BSE Rules, Chapter XV.

[18] *See generally* BSE Rules, Ch. XV (rules governing the responsibilities of specialists). The Commission notes that all BSE specialists, including Competing Specialists, affiliated with an approved person must have proper information barriers in place in conformance with BSE Rules, Ch. II, § 36. *See* Securities Exchange Act Release No. 34076, (May 18, 1994) 59 FR 26822 (May 24, 1994).

[19] *See* BSE Rules, Ch. VIII and Ch. XII.

[20] The decision of the MPC may be appealed to the Executive Committee.

[21] Any objection by the regular specialist to permit competition in one or more of such specialist's stock must be in writing and filed with the Exchange within 48 hours (unless the specialist is unavailable, in which case within 48 hours of becoming available) of notice of filing of the competing specialist application. The MPC may not deny applications based solely on such an objection. Rather, it is only to be used in circumstances wherein the stock at issue requires special treatment such that an entering competitor could jeopardize the fair and orderly market maintained by the regular specialist.

[22] Once competition begins in a security, any subsequent reallocation will bar objection rights from that day forward.

[23] A ''caretaker'' is a specialist from another specialist unit who is chosen by the Exchange to temporarily act as the regular specialist.

allowing orders to be directed to a particular specialist for execution against itself) deny such orders the benefits and protections of auction market trading[24]. As a result, Ms. Gavin believes such orders do not get the benefit of potential price improvement, nor do they add to the pricing mechanism of the national market system. Ms. Gavin therefore believes that preferencing programs should not be permitted to continue.

The Commission received two letters that included preliminary drafts of an academic paper from Indiana University that studies the short term effects of preferencing on market quality (''IU Study'').[25] The IU Study looked for potential shifts in market share, bid/ask spreads, and liquidity premiums for 34 NYSE-listed securities that were traded pursuant to the CSI pilot between July 1994 and March 1995. The IU Study's preliminary results indicate that the introduction of competing specialists on the BSE appears to have substantially increased the BSE's trade volume in the 34 stocks and that, in particular, the share of small trades executed on the BSE doubled in short period of time. The IU Study found, however, that over the short term studied the effects of competing specialists on market quality appear to be minimal. Although the IU Study found that spreads and liquidity premiums decreased, [26] it concludes that this decrease is not statistically significant because of the limited number of stocks studied. The IU study further notes that, to the extent that retail brokers internalizing trades reduce (or even eliminate) commissions, investor welfare is improved.

V. Data Summary

In its approval of the CSI pilot, the Commission requested that the BSE provide, through specified periodic reporting requirements, data regarding the CSI's effect on competition on the BSE and within the national market system. Since the commencement of the CSI pilot, the Exchange has submitted to the Commission several reports that contained trade and share data for stocks traded on the BSE.[27]

The data provided by the Exchange indicated that trade and share volume for the BSE overall increased during the CSI pilot.[28] The data also indicated that Competing Specialists have received a substantial amount of order flow in CSI stocks. Specifically, the most recent BSE report states that in December 1995, orders directed to a Competing Specialist accounted for 58% of total trades and 43% of total shares executed in CSI issues.[29] In addition, the data showed that the depth of the limit order book generally increased in CSI stocks during the pilot, and that approximately 25% of the orders directed to the Competing Specialist were limit orders.[30] Furthermore, over the last year, between 12% and 21% of the orders directed to a Competing Specialist were executed against limit orders on the Exchange's consolidated book.[31]

The data was mixed in regard to whether the CSI has increased competition on the BSE. Specifically, the BSE reported that regular specialists executed less than 1% of the orders directed to Competing Specialists.[32] Under CSI rules, regular specialists would have executed a higher percentage of the orders directed to Competing Specialists had they been aggressively quoting at the ITS/BBO.[33] BSE data also indicated, however, that the CSI may contribute to the BSE's competitiveness within the national market system. The Exchange reported that during November 1995, BSE quotes matched at least one side of the ITS/BBO more often in CSI stocks than in a comparable sample of BSE-traded issues in which there was only one specialist.[34]

VI. Discussion

After careful review of the competing specialist program, and for the reasons discussed below, the Commission believes that approval of the CSI is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission believes the proposal is consistent with Section 6(b)(5) of the Act,[35] which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade and to perfect the mechanism of a free and open market and a national market system and to protect investors and the public interest. The competing specialist program also is consistent with Section 11A of the Act,[36] which generally promotes, among other things, the development of a national market system for securities to assure economically efficient execution of securities transactions and fair competition among brokers and dealers, among exchange markets and markets other than exchange markets.

The Commission supports efforts by exchanges to provide increased liquidity and competition on their trading floors or trading systems. Such efforts can enhance market quality and enable exchanges to compete more effectively for order flow. The BSE's competing specialist program was designed to improve BSE market making and, although the data is mixed, it appears as though the CSI has provided some increased competition and order interaction on the BSE floor. At the same time, the Commission is sensitive to concerns presented by internalized order flow and its potential effect on the

[24] *See* letters from Paula Gavin, Chair, NYSE Individual Investors Advisory Council, to Chairman Levitt, SEC, dated July 17, 1995, and October 2, 1995.

[25] *See* letter from Robert Jennings, Faculty Fellow and Professor of Finance, Indiana University School of Business, to Jonathan Katz, Secretary, SEC, dated June 30, 1995; and letter from Robert Battalio, Assistant Professor University of Notre Dame, to Jonathan G. Katz, Secretary, SEC, dated March 6, 1996 (''IU Study'').

[26] The liquidity premium measures the closeness of transaction prices to the mid-point of the quotation spread. Thus, a decrease in the liquidity premium indicates that transaction prices have moved closer to the mid-point of the spread.

[27] The reports are available in the public file. *See* Competing Specialist Initiative Report, submitted to the Commission on February 13, 1995 (''BSE Report No. 1''); letter from Karen Aluise, Assistant Vice President, BSE, to N. Amy Bilbija, Attorney, SEC, dated April 28, 1995 (''BSE Report No. 2''); and letter from Karen Aluise, Assistant Vice President, BSE, to Glen Barrentine, Senior Counsel, SEC, dated February 14, 1996 (''BSE Report No. 3'').

[28] The BSE reports, for example, that for the month of December 1994, there were 171,075 trades and 106,753,284 shares executed on the Exchange. For the month of December 1995, 195,272 trades and 120,665,485 shares where executed on the Exchange. The number of reports for all BSE trades to the Consolidated Tape Association (''CTA'') also increased slightly. The BSE reports that in the first quarter of 1994, before the competing specialist program was initiated, CTA trades for the Exchange reached 461,264. *See* BSE Report No. 1, *supra* note 27. In 1995, CTA trades had increased to 475,425 for the first quarter, 564,750 for the second quarter, 550,337 for the third quarter, and 463,616 for the fourth quarter. *See* BSE Report No. 3, *supra* note 27.

[29] The percentage of the total trades and number of shares in CSI issues has increased steadily over the pilot period. *See* BSE Reports Nos. 1, 2, and 3, *supra* note 27.

[30] *See* BSE Reports Nos. 2 and 3, *supra* note 27. The BSE reported that during the month of January 1995, the Exchange had 3457 open limit orders (1,313,576 shares), compared to 6928 open limit orders (11,808,335) during the month of December 1995.

[31] *See* BSE Reports Nos. 2 and 3, *supra* note 27.

[32] *Id.*

[33] As discussed later in this order, the Commission believes that quote competition between the regular specialist and Competing Specialists could be stimulated by system enhancements that allow all specialists to enter their own quotes into BEACON.

[34] Letter from Karen Aluise, Assistant Vice President, BSE, to Glen Barrentine, Senior Counsel, SEC, dated March 5, 1996. The BSE reported that during the month of November, approximately 20% of BSE quotes in 43 CSI stocks matched at least one side of the ITS/BBO. In a sample of 44 non-CSI stocks, only approximately 17% of the BSE's quotes matched at least one side of the ITS/BBO. The BSE also indicated that for both groups of stocks, the BSE produced approximately 1% of all quotes that established a new ITS/BBO.

[35] 15 U.S.C. 78f(b).

[36] 15 U.S.C. 78k–1.

handling of customer orders and the ability of broker-dealers to fulfil their duty to seek best execution of customers' orders. Accordingly, the Commission has considered, among other things, the CSI's effect on achievement of economically efficient execution of securities transactions, fair competition among brokers and dealers and among exchange markets, as well as the practicability of brokers executing investors' orders in the best market.

The Commission believes that the BSE's competing specialist program, while it may increase internalization, is not necessarily inconsistent with a broker-dealer's duty to seek best execution of customer orders. All limit orders are represented and executed according to the order of their receipt in the BSE's consolidated limit order book (*i.e.*, time priority), irrespective of whether the orders are designated for a particular specialist. Before an incoming market or marketable limit order is routed to a designated specialist, the BEACON system scans the consolidated limit order book for a contra-side order. If there is such an order on the book, BEACON automatically exposes the order to the designated specialist for possible price improvement before matching the order with the contra-side order on the book. This system of matching incoming orders with orders on the BSE's consolidated book ensures that customer market and limit orders are given an opportunity to interact before a specialist can execute the orders against itself, while also providing an opportunity for price improvement for market and marketable limit orders before they are automatically executed. Indeed, the CSI has enhanced order interaction on the BSE by increasing the volume of limit orders sent to the exchange.

While the Commission concludes, for the reasons discussed above, that the CSI is not necessarily inconsistent with a broker-dealer's duty to seek best execution, the Commission recognizes that execution quality is, in large part, dependent on the diligence of BSE members in handling customer orders. While this is true of all markets, it is of particular significance in markets where dealers execute customer orders as principal. It is therefore incumbent on the BASE,[37] as well as the Commission in its oversight capacity, to ensure that BSE members provide best execution of customer orders.

In this regard, the Commission's recent order routing disclosure requirements[38] and its proposed order handling rules[39] signal a renewed emphasis on the importance of price improvement opportunities in connection with the duty to seek best execution. As the Commission has noted, while an automated order routing environment is not necessarily inconsistent with the achievement of best execution, broker-dealers choosing where to automatically route orders must assess periodically the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for their customers' orders.[40] Thus, a broker-dealer may not simply employ default order routing to an affiliated BSE specialist without undertaking such an evaluation on an ongoing basis. A broker-dealer sending orders to the BSE must satisfy itself that its routing decision is consistent with its best execution obligations, irrespective of the firm's desire to internalize order flow through an affiliated BSE specialist. To reach this conclusion, the broker-dealer must rigorously and regularly examine the executions likely to be obtained for customer orders in the different markets trading the security, in addition to any other relevant considerations in routing customer orders.

The Commission also believes that the competing specialist program is reasonably designed to facilitate competition among BSE specialists. A specialist may not execute directed order flow against itself if a competing specialist has priority at the ITS/BBO.[41] By maintaining time priority for quotes at the ITS/BBO, the Commission believes that the BSE's competing specialist program provides an incentive for specialists desiring to attract order flow to enter competitive quotes. Although data collected during the pilot indicates a lack of quote competition presently, the Commission anticipates greater quote competition at the ITS/BBO once Competing Specialists are able to enter their own quotes directly into BEACON. In this regard, the BSE has committed to completing the systems enhancements required to allow the direct entry of quotes by the Competing Specialists within one year of this approval.[42] In addition, as noted above, the program has increased the volume of limit orders. This adds to the depth and liquidity of the BSE market and increases order interaction.

The Commission further believes that the procedures for Competing Specialists are adequate and consistent with the Act. Specifically, Competing Specialists have all of the same rights and obligations of "regular" specialists under the BSE rules and the federal securities laws. In addition, before approving the application for registration as a Competing Specialist, the Exchange will consider the applicant's overall performance evaluation results, financial capability, and adequacy of manpower on the floor. The Commission believes that these criteria are reasonably designed to ensure investor protection.[43]

Finally, the Commission believes it is consistent with the Act for the BSE to remove the restrictions placed on the competing specialist program during the pilot. Specifically, specialists have been prohibited from making cash payments for order flow in those stocks in which they are registered as Competing Specialists. The Commission believed that a limitation on the inducements for preferencing order flow was necessary until the Commission had an opportunity to assess the effects of the CSI pilot. As discussed above, the Commission has assessed the CSI pilot and determined that it is not inconsistent with the Act, nor necessarily, a broker-dealer's obligation to seek best execution. Moreover, lifting the payment for order flow restriction on BSE competing specialists will place them in the same position as the BSE's other members. Accordingly, the

[37] At a minimum, the Commission would expect the BSE, as with any self-regulatory organization, to conduct regular, comprehensive surveillance of the execution quality provided by its members.

[38] *See* Securities Exchange Act Release No. 34902 (October 27, 1994), 59 FR 55006 (November 2, 1994).

[39] *See* Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995).

[40] *Id*. The Commission also noted that the availability of sophisticated order handling systems has made it possible for some broker-dealers and market centers to provide an opportunity for price improvement for their customer orders. The use of these efficient routing and execution facilities by firms and exchanges suggest that price improvement procedures and other best execution safeguards in an automated environment are increasingly practicable and are setting new standards for the industry. *See also* Division of Market Regulation, SEC, *Market 2000 An Examination of Current Equity Market Developments*, (January 1994), at Study V.

[41] System enhancements, to be completed within one year, will allow BEACON to automatically route incoming orders that are not executed against the consolidated limit order book directly to the specialist that has time priority at the ITS/BBO. *See supra* notes 14 and 15.

[42] *See supra* note 15. Failure to complete the systems modifications as agreed would raise serious concerns for the Commission regarding whether the conclusions of this order remain valid.

[43] The fourth criteria specified by the Exchange, objection by the regular specialist, will only be used in stocks presenting special handling considerations and cannot be used by regular specialists as a veto to competition. *See supra* note 21.

Commission believes it is appropriate at this time to remove this restriction.

The Commission also is approving the CSI without the restrictions on the number of Competing Specialists permitted in each stock and the number of stocks in which a single Competing Specialist is permitted to compete. These restrictions only were necessary to limit the scope of the pilot program so that the BSE and Commission could evaluate the effects of introducing Competing Specialists on the floor of the Exchange. The Commission has completed such an evaluation and finds no reason to continue the restrictions.

VII. Conclusion

The Commission believes it is consistent with the Act to allow the BSE to implement its competing specialist program on a permanent basis. In making this determination, the Commission carefully evaluated the data provided by the BSE and other sources, and concluded that the CSI is competitively beneficial to the BSE, while not inconsistent with the attainment of best execution of customer orders, the maintenance of fair and orderly markets, or the protection of investors and the public interest.

Nevertheless, Commission approval of the BSE's competing specialist program is not a determination by the Commission that mere default routing by a firm to its affiliated competing specialist is consistent with a firm's best execution obligations. A broker-dealer associated with a competing specialist must still ensure that its order routing decisions are consistent with its best execution obligations and assess periodically the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for its customers' orders.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[44] that the proposed rule change (SR–BSE–95–02) is approved.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–8398 Filed 4–4–96; 8:45 am]

BILLING CODE 8010–01–M

[44] 15 U.S.C. 78s(b)(2).

[Release No. 34–37046; File No. SR–CSE–95–03]

Self-Regulatory Organizations; The Cincinnati Stock Exchange; Order Granting Approval to Proposed Rule Change to Adopt Permanently Rules Regarding the Preferencing of Public Agency Orders

March 29, 1996.

I. Introduction

On March 1, 1995, The Cincinnati Stock Exchange (''CSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''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 adopt permanently the Exchange rules governing preferenced trading. On August 11, 1995, the Exchange submitted Amendment No. 1 to the proposed rule change to adopt order handling policies for preferencing dealers.

The proposed rule change was published for comment in Securities Exchange Act Release No. 35448 (March 7, 1995), 60 FR 13493 (March 13, 1995). Amendment No. 1 was published for comment in Securities Exchange Act Release No. 36092 (August 11, 1995), 60 FR 42209 (August 15, 1995). The Commission received 18 comment letters on the proposed rule change, which are discussed below.[3] For the reasons discussed below, the Commission has determined to approve the proposed rule change, as amended.

II. Background

In February 1991, the Commission approved a six month pilot program, referred to as the CSE's Dealer Preferencing Program (''DPP''), to modify the Exchange's priority rules to give CSE Designated Dealers [4] priority over same-priced professional interest when interacting with public agency market and marketable limit orders.[5] Originally, the DPP contained limitations on preferencing dealers, including restricting to 60 the number of stocks each preferencing dealer could trade. Since the inception of the program in 1991, the Commission has approved several extensions of the pilot and increases in the number of stocks each preferencing dealer could trade.[6] Currently, the DPP is approved through March 29, 1996, and each preferencing dealer is permitted to trade up to 350 issues.

The CSE initiated the DPP to provide dealers with the ability to retain and execute their internal order flow at the national best bid or offer, provided that public limit orders at the same price on the CSE book were executed first.[7] In proposing the preferencing program, the Exchange noted that it had attempted to increase business and liquidity by developing the National Securities Trading System (''NSTS''), which electronically interfaces with retail order-delivery systems of CSE members, and had attempted to increase the number of issues traded on the Exchange through the creation of the Designated Dealer category of market makers, which are obligated to guarantee execution of all public agency orders up to 2,099 shares.[8] According to the CSE, however, these efforts had not overcome the lack of incentive in CSE's multiple market maker environment for firms affiliated with CSE dealers to direct their retail order flow to the Exchange. Unlike the specialists affiliated with order flow firms on the other regional exchanges, who generally faced little or no market making competition on their floors, the multiple CSE dealers were subject to losing all or a portion of their public orders to other

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See infra* notes 29 to 33, and note 69.

[4] The term ''Designated Dealer'' is defined by the Exchange as a member who maintains a minimum net capital amount and who has been approved by the CSE's Securities Committee to perform market making functions by entering bids and offers into the Exchange's trading system. *See* CSE Rule 11.9(a)(3). In addition, the Designated Dealer status obligates the dealer to guarantee execution of all public agency market and marketable limit orders up to 2099 shares. For issues in which there are more than one Designated Dealer, this execution guarantee obligation rotates on a daily basis. *See* CSE Rule 11.9(c)(iv) and (v).

[5] *See* Securities Exchange Act Release No. 28866 (February 7, 1991), 56 FR 5854 (February 13, 1991).

[6] *See* Securities Exchange Act Release No. 29524 (August 5, 1991), 56 FR 38160 (August 12, 1991) (extending pilot through February 7, 1992); Securities Exchange Act Release No. 30353 (February 7, 1992), 57 FR 5918 (February 18, 1992) (increasing number of stocks to 125 and extending pilot through August 7, 1992); Securities Exchange Act Release No. 30809 (June 15, 1992), 57 FR 27990 (June 7, 1992) (increasing number of stocks to 250); Securities Exchange Act Release No. 31011 (August 7, 1992), 57 FR 38704 (August 26, 1992) (extending pilot through May 7, 1993 and increasing number of stocks to 350); Securities Exchange Act Release No. 32280 (May 7, 1993), 58 FR 28424 (May 13, 1993) (extending pilot through May 7, 1994); Securities Exchange Act Release No. 33975 (April 28, 1994), 59 FR 23242 (May 5, 1994) (extending pilot through August 6, 1994); Securities Exchange Act Release No. 34493 (August 5, 1994), 59 FR 41531 (August 12, 1994) (extending pilot through May 18, 1995); Securities Exchange Act Release No. 35717 (May 15, 1995), 60 FR 26909 (May 19, 1995) (extending pilot through October 2, 1995); and Securities Exchange Act Release No. 36324 (September 29, 1995), 60 FR 52436 (October 6, 1995) (extending pilot through March 29, 1996).

[7] *See* Securities Exchange Act Release No. 28866, *supra* note 5.

[8] T3Id.