

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50287; File No. SR-BSE-2004-25)

August 27, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2 and 3 Thereto by the Boston Stock Exchange, Inc. Relating to its Specialist Performance Evaluation Program

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 June 21, 2004, the Boston Stock Exchange, Inc. (“BSE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the BSE. On July 26, 2004, BSE submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On August 25, 2004, BSE submitted Amendment Nos. 2<sup>4</sup> and 3<sup>5</sup> to the proposed rule change. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

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

<sup>3</sup> See letter from John Boese, Vice President, Chief Regulatory Officer, BSE, to Nancy Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated July 22, 2004 and accompanying Form 19b-4 (“Amendment No. 1”). Amendment No. 1 replaced and superceded the originally filed proposed rule change.

<sup>4</sup> See letter from John Boese, Vice President, Chief Regulatory Officer, BSE, to Nancy Sanow, Assistant Director, Division, Commission, dated August 18, 2004 (“Amendment No. 2”). Amendment No. 2 replaced and superceded BSE Rule Chapter XV, Section 17, Paragraph (a) of the previously filed proposed rule change.

<sup>5</sup> See letter from John Boese, Vice President, Chief Regulatory Officer, BSE, to Nancy Sanow, Assistant Director, Division, Commission, dated August 19, 2004 (“Amendment No. 3”). Amendment No. 3 replaced and superceded BSE Rule Chapter XV, Section 17, Paragraph (a) of the previously filed proposed rule change.

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

BSE seeks to amend its rules concerning its Specialist Performance Evaluation Program (“SPEP”). Below is the text of the proposed rule change. Proposed new language is italicized; proposed deletions are in [brackets].

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Chapter XV

Specialists

Specialist Performance Evaluation Program

SEC. 17

(a) All Specialists shall be subject to regular [performance] evaluation [designed to identify areas of performance needing improvement]. The Specialist Performance Evaluation Program shall be administered by the Exchange, subject to the supervision of the Market Performance Committee. The Market Performance Committee will determine, from time to time as it deems necessary, which measures under Rule 11Ac1-5 (“Rule 5”) of the Act shall be used to evaluate Exchange specialists, and the threshold levels of performance against which specialist will be evaluated in each of the relevant Rule 5 measurements. Measurements and threshold levels will be communicated to all members via Floor Memoranda on a periodic basis, at least thirty days in advance, at least each time a new Rule 5 measurement is chosen, or a new threshold established. Specialists will be evaluated for competitive stock allocation purposes and any other purposes for which the Market Performance Committee deems it necessary and/or prudent to have objective standards by which it can evaluate all Exchange specialists

equally. Any Specialist whose performance is below acceptable levels established by the Market Performance Committee shall be subject to specific improvement actions as determined by the Market Performance Committee as set forth in paragraphs 2156.10 through 2156.80.

(b) In the event that the performance of a Specialist is below acceptable performance levels, notice of such fact shall be given to the Specialist.

(c) Set forth below are the conditions warranting performance improvement action:

(i) Any Specialist who receives a deficient score in one objective measure in any review period shall be deemed to have a deficient performance, and shall be required to attend an informal meeting with the [Performance Improvement Action] Market Performance Committee to discuss possible methods of improving his/her performance. If a[A]ny Specialist [who] receives a deficient score in any one objective measure for two out of three consecutive review periods, [shall be required to appear before] the Market Performance Committee[, which] shall take such actions as it deems necessary and appropriate to address the deficient score, including imposing actions as specified in the Supplemental Material.

(ii) Those Specialists that fall below the threshold level for the overall performance evaluation program in any evaluation review period shall be required to appear before the Market Performance Committee, which shall take such actions it deems necessary and appropriate to address the deficient performance. (See Supplemental Material for possible actions.)

[(iii) Exceptions. Where Specialists have threshold scores in each measure at the following levels (subject to change pursuant to Commission approval), they will be deemed to have adequately performed:

Overall Evaluation Score --at or above weighted score of 5.00

Turnaround Time --below 21.0 seconds (5 points) (5%)

Holding Orders Without Action --below 21.0% (5 points) (5%)

Price Improvement in<8th Markets --at or above 2.0% (5 points) (20%)

Price Improvement in 8th Markets --at or above 15.0% (5 points) (15%)

Price Improvement in>8th Markets --at or above 25.0% (5 points) (15%)

Depth --at or above 75.0% (5 points) (20%)

Added Depth --at or above 1.0% (5 points) (20%)]

(d) The Specialist shall be notified in writing of the basis for such action and shall have an opportunity to submit a written reply no later than ten days after the receipt of such notice.

(e) The Specialist shall also have an opportunity to be heard upon the specific grounds to be considered before the Market Performance Committee and a written record of any such hearing shall be maintained. Following any such proceeding, the Market Performance Committee will inform the Specialist in writing of its decision and any actions to be imposed, and its reasons therefore. The decision of a majority of the members of that Committee shall be final, subject to the power of the Board of Governors to review such decision in accordance with the provisions of Article II, Section 6 of the Constitution.

**Supplementary Material:**

.10 Stock Reallocation --Notice of Particular Stock --Together with written notice of the specific grounds to be considered as the basis for withdrawal of approval, the Market Performance Committee will give the member written notice of the particular stock or stocks to be considered for withdrawal of approval and give a written explanation of the basis on which the stock or stocks were selected.

.20 Stock Reallocation --Selection of Particular Stocks --In designating a particular stock or stocks to be considered as the basis for withdrawal of approval, the Market Performance Committee shall consider indications of weaknesses in specialist performance in individual stocks to the extent such indications are available. Such indications of weak performance may include, among other factors, references to a particular stock by those responding to initial or supplemental evaluation questionnaires, references in such questionnaires to weaknesses in performance of a type which relate to a particular stock or groups of stocks, and/or indications of weaknesses as demonstrated by the objective measures in such stock or stocks.

When the available measures of Specialist performance indicate weak performance generally, and not precisely in any particular stock or stocks, the Market Performance Committee may decide nonetheless to withdraw approval for a particular stock or stocks.

In any case, the Market Performance Committee will exercise its best judgment to select a stock or stocks as to which a reallocation by the Stock Allocation Committee is likely to result in improved Specialist performance.

.30 Trading and/or Alternate Specialist Account Suspension --A Specialist that meets a condition for review subject to the Specialist Performance Evaluation Program criteria after one review period resulting in a deficient score for the overall evaluation program or

for two review periods with a deficient score in any one objective measure shall be put on notice that approval for his or her trading account or Alternate Specialist Account may be suspended if the Specialist receives a deficient score in the subsequent review period and may continue until the Specialist's scores meet the threshold levels as set forth in Paragraph 2156(d).

.40 Other Action --The Market Performance Committee, in addition to the foregoing actions, may take such other action as it deems appropriate to address deficient performance of a Specialist.

.50 While reallocated stocks will not be restored upon the improved performance of a Specialist, a Specialist may, with the approval of the Market Performance Committee, have lifted one or more of the actions previously imposed.

.60 The Market Performance Committee, in determining which action(s) should be applied against a deficient Specialist, will use the following guidelines to determine the order of actions, but in its discretion may apply them in any order or may apply more than one in a given situation:

- (i) Suspension of trading account privilege.
- (ii) Suspension of Alternate Specialist account privilege.
- (iii) Stock reallocation.

.70 In the event that a Specialist is ranked in the bottom ten percent but does not fall below the threshold level for the overall evaluation program, Exchange staff will review the performance of the Specialist to determine if there is sufficient reason to warrant informing the [Performance Improvement Action]Market Performance Committee of potential performance problems.

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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

The rules governing the Exchange's SPEP program, set forth in Chapter XV, Dealer-Specialists, Section 17, Specialist Performance Evaluation Program, of the BSE Rules, were approved in their current form in 1998,<sup>6</sup> primarily for use in ranking BSE specialists for performance measurement and stock allocation purposes. The SPEP program currently operates on a pilot basis, with the current pilot approved through September 30, 2004.<sup>7</sup> The Exchange now believes that the SPEP program is outdated and redundant with several measures required under Rule 11Ac1-5 under the Act<sup>8</sup> ("Rule

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<sup>6</sup> See Securities Exchange Act Release No. 39730 (March 6, 1998), 63 FR 12847 (March 16, 1998) (File No. SR-BSE-97-09). Telephone conversation between John Boese, Vice President, Chief Regulatory Officer, BSE, and David Liu, Attorney, Division, Commission, on August 2, 2004.

<sup>7</sup> See Securities Exchange Act Release No. 49525 (April 2, 2004), 69 FR 18994 (April 9, 2004) (File No. SR-BSE-2004-12).

<sup>8</sup> 17 CFR 240.11Ac1-5.

5”).<sup>9</sup> The BSE proposes to eliminate the current measurement standards set forth in its SPEP program and replace them with a ranking program based on statistics reported under Rule 5. The statistics to be utilized would vary from time to time, as determined by the Exchange’s Market Performance Committee. The Market Performance Committee of the Exchange has approved the proposal to replace the current SPEP measurements with existing Rule 5 measurements.

The BSE states that the primary purpose for the replacement of the current SPEP measurements is the duplicative nature between them and the measurements required under Rule 5. Both SPEP and Rule 5 require that the BSE make available monthly reports of statistical information concerning Exchange specialists’ order executions. The Exchange believes that this provides a means to evaluate the performance of specialists, which encourages visibility and competition, particularly on the factors of execution price and speed. According to the BSE, the rankings have also been utilized by the Exchange’s Stock Allocation Committee as a consideration in competitive stock allocations.

SPEP currently measures 7 different categories against BSE floor averages, with threshold levels for each measure. Rule 5 has numerous categories, many of which correspond to the Exchange’s SPEP measurements currently utilized. The categories currently measured in the SPEP program are:

Price Improvement- .01-.05

Price Improvement- .06-.15

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<sup>9</sup> See Securities Exchange Act Release No. 43590 (November 17, 2000), 65 FR 75414 (December 31, 2000) (adopting Rule 5).

Price Improvement- > .15

Depth

Added Depth

Turnaround Time

Holding Orders w/o Actions

In comparison, Rule 5 has three main measurements (security, order type, and order size) each subcategorized by 11 smaller measurements. For market orders and marketable limit orders there are an additional 9 sub-measurements. The Exchange believes that the Rule 5 measurements provide a much broader view on which to base the performance of specialists. By utilizing existing statistics required under Rule 5, the BSE believes it would be expanding its current evaluation of specialists and avoiding repetition and confusion. For instance, instead of the current measurements, the Exchange could evaluate specialist performance in such Rule 5 measurements as those addressing average effective spread, price improvement, liquidity enhancement, away shares and time of execution.

The proposed rule text would not set forth specific Rule 5 measurements which will be utilized. Rather, the Exchange seeks to have the Market Performance Committee determine, from time to time as conditions warrant, which Rule 5 statistics would be utilized as measurement criteria for ranking specialists. The Market Performance Committee's determinations would be disseminated to all Exchange members via Floor Memorandum at least thirty days prior to their application, as is currently the practice.

The Exchange believes that its proposal would give the Market Performance Committee the flexibility to respond to market conditions or future changes in the

Exchange's rules which may obviate or change the reason for a particular SPEP measurement. For example, according to the BSE, one of the primary reasons the BSE started the SPEP program was to provide its Stock Allocation Committee with an additional criteria during deliberations of competitive stock allocations. However, with the expansion of the Exchange's Competing Specialist Initiative, the instances of competitive stock allocations have been greatly reduced. The Exchange believes that future changes to the Exchange's rules may likewise render a particular SPEP measurement moot in favor of another Rule 5 measurement, or none at all. Therefore, the Exchange seeks to give its Market Performance Committee the ability to determine which Rule 5 statistics should be used to rank Exchange specialists, as necessitated by market conditions, rule changes or other factors.

The proposed rule change would leave intact the disciplinary procedures set forth throughout the SPEP rules. Although the Exchange believes that economic forces will compel specialists to maximize their performance so as to receive the benefits of directed order flow, the BSE also believes that there is some merit to providing for punitive and other actions to encourage specialists to perform at least at a threshold level.

Finally, the Exchange is also proposing to replace the Performance Improvement Action Committee in the rule text with the Market Performance Committee. The Performance Improvement Action Committee was a subcommittee of the Market Performance Committee which has been abolished, and its duties have been subsumed by the Market Performance Committee.<sup>10</sup>

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<sup>10</sup> The Performance Improvement Action Committee was abolished as of January 1, 2004. Telephone conversation between John Boese, Vice President, Chief

## 2. Statutory Basis

The Exchange believes that the proposed rule change, as amended, is consistent with Section 6(b) of the Act<sup>11</sup> in general, and furthers the objectives of Section 6(b)(5)<sup>12</sup> in particular, in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating securities transactions, 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.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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Regulatory Officer, BSE, and David Liu, Attorney, Division, Commission, on August 11, 2004.

<sup>11</sup> 15 U.S.C. 78f(b).

<sup>12</sup> 15 U.S.C. 78f(b)(5).

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

No written comments were either solicited or received.

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change; or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-BSE-2004-25 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-BSE-2004-25. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site

(<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the BSE. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available

publicly. All submissions should refer to File Number SR-BSE-2004-25 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>13</sup> 17 CFR 200.30-3(a)(12).