

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-51251; File No. SR-BSE-2004-27)**

**February 24, 2005**

**Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment No. 1 Thereto by the Boston Stock Exchange, Inc., Relating to the Reporting of Riskless Principal Transactions**

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 December 3, 2004, the 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 and II below, which Items have been prepared by the Exchange. On December 23, 2004, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice and order to solicit comments on the proposed rule change, as amended, from interested persons and to grant accelerated approval to the proposal.

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

BSE is proposing to adopt a rule pertaining to the reporting of riskless principal transactions. Proposed new language is italicized.

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**Chapter II**

**Dealings on the Exchange**

Secs. 1- 43 No change.

Riskless Principal Transactions

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

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

Sec. 43

- (1) A "riskless principal transaction" is a two-legged transaction in which a member, (i) after having received an order to buy a security that it holds for execution on the Exchange, contemporaneously purchases the security as principal at the same price, exclusive of markups, markdowns, commissions and other fees, to satisfy all or a portion of the order to buy or (ii) after having received an order to sell a security that it holds for execution on the Exchange, contemporaneously sells the security as principal at the same price, exclusive of markups, markdowns, commissions and other fees, to satisfy all or a portion of the order to sell.
- (2) A last sale report for only the initial principal leg of the transaction shall be submitted in accordance with the rules and procedures of the market where the transaction occurred. The second "riskless principal" leg of the transaction must still be submitted and executed on the Exchange as with any other order, but the Exchange will not report that leg of the transaction to the respective consolidated tape. As applicable, the riskless principal leg may be submitted to the Exchange for execution as either (i) a non-tape, clearing-only order with a "CTA no-print" indicator if a clearing report is necessary to clear the transaction; or (ii) a non-tape, non-clearing order with a "CTA no-print" indicator if a clearing report is not necessary to clear the transaction.
- (3) A member must have written policies and procedures to assure that its riskless principal transactions comply with this Section. At a minimum these policies

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<sup>3</sup>

Amendment No.1 superseded and replaced the original proposal in its entirety.

and procedures must require that the customer order be received prior to the offsetting transactions, and that the offsetting transactions be executed contemporaneously with the original transaction. A member must also have supervisory systems in place that produce records that enable the member and the Exchange to accurately and readily reconstruct, in a time-sequenced manner, all orders for which a member relies on the riskless principal exemption.

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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, as amended, 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 III 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**

Under the proposed rule change, if a member of the Exchange is acting as principal for its own account, its trade would be considered a "riskless principal transaction" to the extent that: (i) after having received an order to buy a security that the member holds for execution on the Exchange, the member purchases the security from another firm or market to offset a contemporaneous sale to satisfy all or a portion of the original buy order at the same price, exclusive of any markup, markdown, commission,

or other fee; or (ii) after having received an order to sell a security that the member holds for execution on the Exchange, the member sells the security to another firm or market to offset a contemporaneous purchase to satisfy all or a portion of the original sell order at the same price, exclusive of any markup, markdown, commission, or other fee.

The Exchange is proposing to adopt a trade reporting rule applicable to riskless principal transactions in any securities traded on the Exchange.<sup>4</sup> Under this proposal, the "initial principal" leg (the "first leg") of the transaction is reported to the consolidated tape by whichever market on which the trade occurs. Pursuant to this rule filing, the BSE member would apply a special marker to the second "riskless principal" leg (the "second leg") and the BSE would not report that leg to the consolidated tape. The first leg of the transaction will continue to be matched and executed on the Exchange or on another market, whichever the case may be, and disseminated for publication to the respective consolidated tape in accordance with the relevant market's requirements. For the second leg of the transaction, to the extent that any of the order is offset by the initial principal execution, the member would designate in its trade report to the BSE the proprietary order as riskless. According to BSE, this BEACON<sup>5</sup> modification will contemporaneously prevent priority violations.

The Exchange represents that BEACON will systematically capture every first leg

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<sup>4</sup> The Exchange currently trades on an unlisted trading privilege basis securities that are listed on the New York Stock Exchange or "Tape A" program, the American Stock Exchange or the "Tape B" program, and the Nasdaq Stock Market or "Tape C" program.

<sup>5</sup> The Boston Exchange Automated Communication Order-routing Network, which is known as BEACON, is the order-routing and execution system utilized on the Exchange.

of every transaction even if it occurs on another market.<sup>6</sup> BEACON will automatically match the first and second leg of the transaction by utilizing tag numbers to ensure that the special marker was used in a riskless principal transaction. More specifically, where a BSE member is executing a trade on another market, BEACON will automatically attach a tag number. This tag number will be matched to the second leg of the transaction. The Exchange will not report the second leg of the transaction to the respective consolidated tape.

Example: A member receives an order to sell 100 shares at \$50 and holds that order for execution on the Exchange. Thereafter the member, as principal, sells 100 shares to another firm at \$50 (the first leg) and then, as principal, fills the original order at \$50 (the second leg). The member designates the filling of the customer order (the second leg) as the "riskless principal" leg of a riskless principal transaction. The Exchange reports the first leg of the transaction to the consolidated tape, but not the second leg.

Procedurally, if the first leg of the transaction occurs on the Exchange, the Exchange will report the first leg of the transaction to the consolidated tape pursuant to its rules. If the first leg of the transaction occurs on another market, that market would report the trade to the consolidated tape according to its rules. The BSE member who has

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<sup>6</sup> See Letter from John Boese, Chief Regulatory Officer, BSE, to Michael Gaw, Senior Special Counsel, Division of Market Regulation, Commission, dated February 10, 2005.

a duty to report the execution<sup>7</sup> shall report the execution as either: (i) a non-tape, clearing-only order with a capacity indicator of "CTA no-print," if a clearing report is necessary to clear the transaction; or (ii) a non-tape, non-clearing order with a capacity indicator of "CTA no-print," if a clearing report is not necessary to clear the transaction.

In addition to the automatic matching of orders, the Exchange will conduct surveillance to determine that both legs of a riskless principal transaction correlate to each other, particularly if one leg occurs on another market. The Exchange will also review to see that members implement written policies and procedures as described below to assure compliance with this proposed rule. To determine that there is a matched order, the two legs of the riskless principal transaction would be electronically reviewed as part of the audit trail used by the Exchange to surveil and regulate trading. On a daily basis, for each execution with an indicator of "CTA no-print," the electronic review will confirm that a contemporaneous order was placed after the customer order was received and the order was executed prior to the execution of the customer order. The electronic review will also confirm that each leg of the riskless principal transaction was executed at the identical price and size. If there is no corresponding matched order, an exception will be generated, and surveillance will conduct a manual review to determine whether the execution was actually a riskless principal transaction and whether the execution should be considered a covered sale.

The Exchange believes that, if the member complies with all aspects of the proposed rule, the sell side of the second leg would be a "recognized riskless principal

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<sup>7</sup> See Rules of the Board of Governor of the Boston Stock Exchange, Chapter II, Dealings on the Exchange, Section 2.

sale," as defined in Rule 31(a)(14) of the Act.<sup>8</sup> Therefore, this sale would not be a "covered sale" as defined in Rule 31(a)(6) under the Act<sup>9</sup> for which the Exchange would incur a liability to the Commission under Section 31 of the Act.<sup>10</sup> Accordingly, the second "riskless principal" leg would not increase the amount of fees that the member owes the Exchange pursuant to Chapter XXIII, Section 2, of the Exchange's rules.

## **2. Statutory Basis**

The Exchange believes that the proposed rule change, as amended, consistent with Section 6(b) of the Act,<sup>11</sup> in general, and Section 6(b)(5) of the Act,<sup>12</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and 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**

BSE does not believe that the proposed rule change, as amended, will impose any inappropriate burden on competition.

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

No written comments were solicited or received in connection with the proposed rule change, as amended.

## **III. Solicitation of Comments**

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<sup>8</sup> 17 CFR 240.31(a)(14).

<sup>9</sup> 17 CFR 240.31(a)(6).

<sup>10</sup> 15 U.S.C. 78ee.

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

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2004-27 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-2004-27. 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

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

and copying at the principal office of 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-2004-27 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

**IV. Commission Findings and Order Granting Accelerated Approval of Proposed Rule Change**

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.<sup>13</sup> Specifically, the Commission believes the proposal is consistent with Section 6(b)(5) of the Act,<sup>14</sup> which requires that the rules of an exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices, 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 rule proposed by BSE is substantially similar to NASD Rule 6420(d)(3)(B) relating to the reporting of riskless principal transactions. The Commission previously has found the NASD riskless principal rule to be consistent with the Act.<sup>15</sup> The Commission believes that BSE's proposal raises no new or significant regulatory issues and is also, therefore, consistent with the Act. Based on the information provided by

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<sup>13</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

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

<sup>15</sup> See, e.g., Securities Exchange Act Release No. 41606 (July 8, 1999), 64 FR

BSE in support of this proposed rule change, the proposal appears reasonably designed to ensure that the two contemporaneous trades for which an Exchange member acts as principal can be matched and are indeed riskless for the member.

Assuming all the requirements of BSE's rule are met, a second offsetting sale occurring on the Exchange would be a "recognized riskless principal sale" as defined in Rule 31(a)(14) under the Act.<sup>16</sup> Therefore, the sale also would be an "exempt sale" as defined in Rule 31(a)(11) under the Act<sup>17</sup> and not a "covered sale" as defined in Rule 31(a)(6) under the Act.<sup>18</sup> The Commission notes, however, that BSE members must have written policies and procedures and supervisory systems in place before reporting trades as riskless pursuant to Chapter II, Section 43 of the Exchange's rules.

The Commission finds good cause for approving the proposed rule change, as amended, prior to the 30<sup>th</sup> day after publication in the Federal Register. The Commission believes that the rule proposed by BSE is substantially similar to NASD Rule 6420(d)(3)(B) and thus raises no new or significant regulatory issues. As such, the Commission believes that accelerated approval is appropriate.

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38226 (July 15, 1999).

<sup>16</sup> 17 CFR 240.31(a)(14).

<sup>17</sup> 17 CFR 240.31(a)(11).

<sup>18</sup> 17 CFR 240.31(a)(6).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>19</sup> that the proposed rule change (File No. SR-BSE-2004-27), as amended, is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>19</sup> 15 U.S.C. 78s(b)(2).

<sup>20</sup> 17 CFR 200.30-3(a)(12).