

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54546; File No. SR-BSE-2006-30)

September 29, 2006

Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Relating to the Implementation of the Second Phase of the Boston Equities Exchange ("BeX") Trading System

**I. Introduction**

On August 3, 2006, the Boston Stock Exchange, Inc. ("BSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, as amended ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change in connection with the implementation of the second phase of the Boston Equities Exchange ("BeX") trading system. In addition, in connection with satisfying the requirements of Regulation NMS under the Act, the BSE proposes several new order types; rules to prevent locked or crossed quotations; a new order routing system; and an order protection rule. The proposed rule change was published for comment in the Federal Register on August 16, 2006.<sup>3</sup> The Commission received no comments regarding the proposal. On September 29, 2006, the BSE filed Amendment No. 2 to the proposed rule change.<sup>4</sup> This order approves the proposed

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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 Securities Exchange Act Release No. 54291 (August 8, 2006), 71 FR 47264.

<sup>4</sup> In Amendment No. 2, BSE made several changes to the proposed rule change, including: (1) introducing a new order type to be known as a Non-Displayed Order; (2) amending the definition of a Preferred Price Cross and ISO Cross; (3) clarifying when certain provisions relating to Regulation NMS become effective; (4) adding provisions for the handling of odd-lot and mixed-lot orders, including the ranking and display of odd-lots and mixed-lots; (5) clarifying the ranking and display of Reserve Orders; (6) adding a provision relating to the anonymity of trades executed by a Member against itself; (7) adding a provision relating to access to BeX by Sponsored Participants; (8) stating that, for purposes of Section 11(a) of the Act (15 U.S.C. 78k(a)) and Rule 11a2-2(T) (17

rule change, grants accelerated approval to Amendment No. 2 to the proposed rule change, and solicits comments from interested persons on Amendment No. 2.

## **II. Summary Description of the Proposal**

BeX is an electronic securities communications and trading facility for equity securities designed to be used by BSE Members, including Electronic Access Members, and their customers. BeX, a facility of the Exchange, was developed, and is owned and operated, by BSX Group, LLC ("BSX").<sup>5</sup> The Commission recently approved rules to implement the first phase of BeX,<sup>6</sup> which is limited to securities listed otherwise than on the NASDAQ Stock Market LLC ("Nasdaq") for which the BSE obtained unlisted trading privileges ("UTP") after June 30, 2006 ("BeX Phase I"). The Exchange now proposes to implement the second phase of BeX ("BeX Phase II") as a fully-automated electronic book for the display and execution of orders in securities listed on any exchange through introducing new, as well as amending certain existing, Rules of the Board of Governors ("BSE Rules").<sup>7</sup> The BSE also proposes to implement new Exchange rules to satisfy the requirements of Regulation NMS.<sup>8</sup>

BeX is a fully-automated electronic book for the display and matching of orders in eligible

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CFR 240.11a2-2(T)) thereunder, all orders for the accounts of Exchange members will be transmitted to the BeX trading system from off the floor (since the Exchange no longer will have any physical trading floor) by electronic means; and (9) making several clarifying changes and correcting several technical errors contained in the rule text. Amendment No. 1 was withdrawn by BSE on September 29, 2006.

<sup>5</sup> See Securities Exchange Act Release No. 54364 (August 25, 2006), 71 FR 52185 (September 1, 2006) (approving the BeX facility and its governance structure).

<sup>6</sup> See Securities Exchange Act Release No. 54365 (August 25, 2006), 71 FR 52192 (September 1, 2006) ("BeX Phase I Order").

<sup>7</sup> The BeX trading rules will be located in Chapter XXXVII of the BSE Rules.

<sup>8</sup> The rules relating to Regulation NMS requirements will be located in Chapter XXXVIII of the BSE Rules.

securities, without the participation of a specialist.<sup>9</sup> Securities traded on BeX cannot also be traded by a BSE specialist.<sup>10</sup> The Exchange has indicated that implementation of BeX is scheduled to occur on October 30, 2006. Accordingly, there no longer will be any specialist participation in any transactions on the BSE or otherwise as of such implementation. The Exchange, however, proposes to add rules to permit participation by market makers in BeX as part of the instant proposed rule change.

In connection with satisfying the requirements of Regulation NMS, the Exchange proposes to offer several execution enhancements, including additional order types, a rule aimed at the prevention of locked or crossed markets, electronic order routing, and an order protection rule, as it transitions to a fully electronic trading venue with its BeX facility and in accordance with the implementation of Regulation NMS. The Exchange expects that initially the current trading rules of the BSE will remain largely intact,<sup>11</sup> as supplemented by the BeX Phase I rules previously approved by the Commission, and the rule changes contained herein relating to the BeX facility, including rule changes required under Regulation NMS.

### **III. Discussion**

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations promulgated thereunder applicable to a

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<sup>9</sup> See BeX Phase I Order, *supra* note 6.

<sup>10</sup> See Chapter XXXVII, Section 1 of the BSE Rules.

<sup>11</sup> The Exchange has represented that within thirty days of full implementation of the BeX trading system, it intends to file a proposed rule change under Section 19(b)(1) of the Act, which will be designed to eliminate all rules that are no longer applicable as a result of the transition from the traditional floor-based model of trading to the all-electronic BeX platform. The Exchange notes, for example, that rules related to specialists will be removed as there will no longer be any specialist participation in any transactions on the BSE or otherwise.

national securities exchange<sup>12</sup> and, in particular, with the requirements of Section 6(b) of the Act.<sup>13</sup> Specifically, the Commission finds that approval of the proposed rule change is consistent with Section 6(b)(5) of the Act<sup>14</sup> in that it is designed to facilitate transactions in securities; to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to foster cooperation and coordination with persons engaged in regulating, clearing, settling, 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.

#### **A. Eligible Securities**

Under the rules approved in connection with BeX Phase I, all securities eligible for trading on the Exchange that are listed otherwise than on Nasdaq for which the BSE obtains UTP after June 30, 2006 would be eligible for trading in the BeX. The Exchange has proposed to amend this definition to allow all securities eligible for trading on the Exchange to be eligible for trading in the BeX. In Amendment No. 2, the Exchange proposes to allow the BeX to accept and execute mixed-lot and odd-lot orders in Nasdaq Global Market securities and Nasdaq Capital Market securities. BeX will continue to only accept and display round-lot orders for securities listed on exchanges other than the Nasdaq.

The Commission finds that the Exchange's proposal to expand the category securities eligible to be traded on BeX is consistent with the Act.

#### **B. Eligible Orders**

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<sup>12</sup> In approving this proposal, 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(b).

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

Under BeX Phase I, orders eligible for execution in the BeX may be designated as one of the following existing BSE order types: “at the close,” “at the opening or at the opening only,” “day,” “do not increase (DNI),” “do not reduce (DNR),” “fill or kill,” “good ‘till cancel,” “immediate or cancel (“IOC”),” “limit, limited or limited price,” “market,” “stop limit,” or “stop,” “cross,” “cross with size,” “good ‘till date (GTD),” “good ‘till time (GTT),” “limit or close,” “mid-point cross,” and “post primary cross.”<sup>15</sup> The Exchange has proposed to amend Chapter XXXVII, Section 2 of the BSE Rules to add the following additional orders types as part of BeX Phase II: “reserve order,” “minimum quantity order,” “preferred price cross,” “automatic immediate or cancel” (“AIOC”), “best price intermarket sweep order” (“BPISO”), “ISO cross order,” “price-penetrating ISO”, “cancel on corporate action order,” and “non-displayed order.”<sup>16</sup> Best price intermarket sweep, price-penetrating ISO, ISO Cross and AIOC orders would not be eligible for submission to BeX until February 5, 2007, which is the Trading Phase Date under Regulation NMS.<sup>17</sup> Descriptions of the proposed order types are as follows:

**Reserve Order:** A reserve order is a limit order with a portion of the size displayed and with a reserve portion of the size that is not displayed. A reserve order could not be an IOC order or market order. The displayed portion of a reserve order (not the reserve portion) would be ranked at the specified limit price and the time of order entry with its initial display quantity. If the displayed portion of a reserve order is decremented such that an odd-lot quantity remains from the initial displayed quantity, the odd-lot quantity would not be displayed, but would keep its ranking in time priority. If the displayed portion of a reserve order is decremented such that a

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<sup>15</sup> These order types were approved in the BeX Phase I approval orders. See supra note 6.

<sup>16</sup> These new order types are being proposed in connection with the proposed rules relating to Regulation NMS but will be located in Chapter XXXVII of the BeX Rules.

<sup>17</sup> See Securities Exchange Act Release No. 53829 (May 18, 2006), 71 FR 30038 (May 24, 2006).

mixed-lot quantity remains from the initial displayed quantity, only the round lot portion of the mixed-lot quantity would be displayed, but both the round-lot and odd-lot portions of the mixed-lot quantity would keep their rankings in time priority. A reserve order would be replenished when the initial display quantity had been executed in its entirety.

As proposed, the displayed portion of a reserve order would be replenished for: (1) the initial display quantity; or (2) if the remaining reserve quantity is smaller than the initial display quantity, the entire reserve quantity; provided that any odd-lot amount or odd-lot portion of the mixed-lot would not be displayable, but would nevertheless be ranked in time priority as of the time it would have been displayed as a part of the replenishment had it not been an odd-lot quantity and would be handled in accordance with the applicable provisions of Chapter XXXVII, Section 3(i) of the BSE Rules.

**Minimum Quantity Order:** A minimum quantity order is an order subject to the provisions of Chapter XXXVII, Section 6 of the BSE Rules (Orders to be Reduced and Increased on Ex-Date), that, upon entry, would be executed at least at its minimum quantity or the order would be cancelled. If executed in part, the remaining quantity would remain in the book and follow the execution rule for the order type. A stop limit order could be designated as a minimum quantity order and, at the election of the order, would be handled pursuant to Chapter XXXVII, Section 3(j) of the BSE Rules.

**Preferred Price Cross Order:** A preferred price cross order is a two-sided cross order with a “preferred limit price” set by the Member. A preferred limit price would be the limit price at which the two-sided cross order would be executed, if it is better than the best bid and offer displayed on BeX and equal to or better than the National Best Bid or National Best Offer. When the preferred limit price does not meet the above conditions, the execution price of the

order would be the closest price above or below the preferred limit price, such that the execution price is better than the best bid and offer displayed on BeX and equal to or better than the National Best Bid or National Best Offer by a Minimum Price Variation.<sup>18</sup> For example, if the best bid and offer displayed on BeX is 2.00 to 2.05 and the National Best Bid and Offer is 2.01 to 2.05, and the Preferred Limit Price is 1.99, the order would execute at 2.01. When the best bid and offer on BeX are equal to the National Best Bid and Offer and are one Minimum Price Variation apart, the execution price will be at the midpoint of the National Best Bid and Offer. For example, if the Best Bid and Offer displayed on BeX is 2.00 to 2.01, the National Best Bid and Offer is 2.00 to 2.01, and the Preferred Limit Price is 1.99, the order would execute at 2.005.

**AIOC Order:** An automatic immediate or cancel order would be an order received on BeX that would execute immediately and automatically, either in whole or in part, at or better than its limit price, with any unexecuted balance of the order to be immediately cancelled. The unexecuted portion of the order would not be routed to another Trading Center. AIOC, unlike IOC orders, cannot be submitted until February 5, 2007, or an exemption from the ITS Plan is obtained.

**Best Price ISO:** A BPISO is an order marked as required by Rule 600(b)(30) of Regulation NMS that would be executed against any orders at the Exchange's Best Bid or Best Offer (including any undisplayed orders at that price) as soon as the order is received by the BSE, with any unexecuted balance of the order to be immediately cancelled. The BSE, in executing a BPISO, would not take any of the actions described in Chapter XXXVIII, Section 4 of the BSE Rules to prevent an improper trade through. BPISOs would not be eligible for submission to BeX until February 5, 2007.

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<sup>18</sup> "Minimum Price Variation" is defined in Chapter II, Section 41 of the BSE Rules. The Exchange has proposed to amend this definition to account for the situation where a Preferred Price Cross Order is executed at a price that is one half the Minimum Price

**Price-Penetrating ISO:** A price-penetrating ISO is an order marked as required by Rule 600(b)(30) of Regulation NMS that would be executed at or better than its limit price as soon as the order is received by the BSE, with any unexecuted balance of the order to be immediately cancelled. Price-penetrating ISOs would be executed against any eligible orders at the BSE through multiple price points (including any undisplayed orders). The BSE, in executing these orders, would not take any of the actions described in proposed Chapter XXXVIII, Section 4 of the BSE Rules to prevent an improper trade-through, as defined therein. Price-penetrating ISOs would not be eligible for submission to BeX until February 5, 2007.

**ISO Cross Order:** An ISO cross order is a two-sided order that, upon receipt, would be executed without any action on the part of the Exchange to prevent an improper trade-through. The cross price must be priced better than the best bid or offer displayed in BeX. ISO Cross orders would not be eligible for submission to BeX until February 5, 2007, or an exemption from the ITS Plan is obtained.

**Cancel on Corporate Action Order:** An order designated as a cancel on corporate action order would be cancelled in the event of a dividend, distribution or stock split in the subject security.

**Non-Displayed Order:** A non-displayed order is a limit order, limit or close order or stop limit order that is not displayed in BeX, but the order would remain available for potential execution against all incoming orders until executed in its entirety or cancelled. In the event a non-displayed order that crosses the National Best Bid or Offer is entered, that order would either be cancelled or, at the instruction of the member entering the order, routed to an away Trading Center(s). Similarly, if a non-displayed order already on the BeX book crosses the

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Variation.



National Best Bid or Offer as a result of movement in the marketplace, that order would either be cancelled or, at the instruction of the member entering the order, routed to an away Trading Center(s). Non-displayed orders required to be routed to an away Trading Center(s) would be routed as displayed orders.

The Commission believes that these order types are appropriate in the context of the trading services proposed to be offer by the BeX facility and are consistent with the Act. In addition, the BSE's proposal regarding reserve orders and non-displayed orders comport with rules the Commission previously approved for other exchanges.<sup>19</sup> The Commission notes that these order types should help provide market participants with flexibility in executing transactions that meet the specific requirements of the order type.

### **C. Access**

The Exchange proposes that BeX would be available for entry and execution of orders by Member Organizations and Sponsored Participants with authorized access. To obtain authorized access to BeX, each Sponsored Participant would be required to enter into a BeX Participant Agreement. A Sponsored Participant could obtain authorized access to BeX only if such access is authorized in advance by one or more Sponsoring Member Organizations. Sponsored Participants would be required to enter into and maintain customer agreements with one or more Sponsoring Member Organizations establishing the proper relationship(s) and account(s) through which the Sponsored Participant may trade on BeX. Such customer agreement(s) would be required to incorporate the sponsorship provisions set forth in proposed Chapter XXXVII, Section 5 of the BSE Rules. The proposed rule change sets forth the requirements and procedures to be followed by the Sponsored Participant and the Sponsoring Member Organization.

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<sup>19</sup> See, e.g., NYSE Arca Rule 7.31(h)(3).

The Commission believes that the proposed sponsored access provisions are appropriate and notes that they comport with rules the Commission previously approved for other exchanges.<sup>20</sup>

**D. Compliance with Intermarket Trading System (“ITS”) Plan.**

As set forth in Chapter XXXVII, Section 3(j) of the BSE Rules, to ensure compliance with the ITS Plan as long as it remains in effect, otherwise eligible orders would be cancelled or routed away in certain circumstances. For example, marketable orders that would trade through the National Best Bid or National Best Offer would either be cancelled or be routed to the market(s) showing the National Best Bid or National Best Offer at the order-entering firm’s instructions. In addition, if an order in an ITS eligible security crosses or locks the National Best Bid or National Best Offer at the time that it is received, the order would be immediately cancelled to ensure compliance with the ITS Plan’s rules relating to locked markets.<sup>21</sup>

**E. Ranking and Display of Orders for Undisplayed Orders and Odd-Lot and Mixed-Lot Orders**

As set forth in Chapter XXXVII, Section 3(i) of the BSE Rules, displayed orders on BeX would be ranked in price/time priority. Within each price level, orders would be ranked in time priority based on the time the order is displayed. As noted above, the Exchange proposes to allow reserve orders (i.e., part of the order is displayed) and non-displayed orders (i.e., no part of the order is displayed). Under the Exchange's proposed amendment to Chapter XXXVII, Section 3(i) of the BSE Rules, reserve quantities of reserve orders would be considered displayed when replenished. Undisplayed orders on BeX, such as non-displayed orders and reserve quantities of

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<sup>20</sup> See, e.g., NYSE Arca Rule 7.29.

<sup>21</sup> Similarly, if an order in a listed security locks or crosses the Best Bid or Best Offer in BeX at the time it is received, but not the National Best Bid or National Best Offer, the order would be executed according to BeX’s matching algorithm, and any remaining portion would be immediately cancelled, if it would lock or cross the National Best Bid or National Best Offer.

reserve orders, would be ranked after all other displayed orders at that price level and would be ranked in time priority among all undisplayed orders. The Exchange provided the following example of the ranking process between displayed and undisplayed orders:

At 9:30 a.m., a reserve order to buy 500 shares is entered. The initial display quantity is 200 shares and the undisplayed reserve quantity is 300 shares.

At 9:32 a.m., a non-displayed order to buy 300 shares is entered.

At 9:33 a.m., a reserve order to buy 200 shares is entered. The initial display quantity is 100 shares and the undisplayed reserve quantity is also 100 shares.

At 9:34 a.m., an order to sell 1,000 shares at market is entered.

Assuming all the buy orders are at the same price level, the 1,000 shares will execute against the following orders:

200 shares of the displayed portion of the 9:30 a.m. reserve order.

100 shares of the displayed portion of the 9:33 a.m. reserve order.

300 shares of the undisplayed reserve quantity of the 9:30 reserve order.

300 shares of the undisplayed portion of the 9:32 a.m. non-display order.

100 shares of the undisplayed reserve quantity of the 9:33 a.m. reserve order.

The proposed revision to Chapter XXXVII, Section 3(i) of the BSE Rules also sets forth the handling of odd-lot and mixed-lot portions for reserve orders. In addition, the proposed rule revision states that while BeX would only accept and display round-lot orders for securities listed on exchanges other than Nasdaq, it would accept odd-lot and mixed-lot orders for Nasdaq Global Market securities and Nasdaq Capital Market securities. The proposed amendment to Chapter XXXVII, Section 3(i) of the BSE Rules would indicate how odd-lot share amounts would be handled in BeX for these Nasdaq-listed securities.

The Commission believes that the proposed rule revisions relating to ranking and display of orders, including odd-lot and mixed-lot portions of reserve orders and the handling of odd-lot and mixed-lot components of orders for Nasdaq securities, are consistent with the Act.

**F. Anonymity**

The Exchange has proposed to amend Chapter XXXVII, Section 3(i) of the BSE Rules to state that BeX will provide pre-trade anonymity for all submitted orders, except as otherwise permitted by the proposed rule. All display-eligible orders (non-displayed orders and reserve portions of reserve orders are not display-eligible) at all price levels on the BeX would be displayed to all Members on an anonymous basis and transactions executed on the BeX would be processed anonymously.<sup>22</sup> Transaction reports would indicate the details of the transaction, but would not reveal contra party identities. No Member having the right to trade through the facilities of BeX and who has been a party to or has knowledge of an execution would be under an obligation to divulge the name of the buying or selling firm in any transaction. Except as otherwise provided for in the BSE Rules, no Member would be permitted to transmit through the facilities of BeX any information regarding a bid, offer, other indication of an order, or the Member's identity, to another Member until permission to disclose and transmit such bid, offer,

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<sup>22</sup> The Exchange indicated that it intends to request a limited exemption from the staff of the Commission from paragraph (a)(2)(i)(A) of Rule 10b-10 under the Act on its own behalf and/or on behalf of its Members who execute trades on the BeX. The exemption request will be limited to those trades that BSE Members execute on BeX with other BSE Members when using the anonymous feature of BeX's electronic trading system. The BSE also intends to request assurance that the Commission staff would not recommend enforcement action to the Commission if, in lieu of making and preserving a separate record, BSE Members rely on the BSE's retention of the identities of the BSE Members that execute anonymous trades through BeX to satisfy the requirements of Rules 17a-3(a)(1) and 17a-4(a) under the Act, 17 CFR 240.17a-3(a)(1) and 17a-4(a), respectively. The Exchange has represented that it will not implement the anonymity feature of BeX unless and until the requested relief is granted.

other indication of an order, or the Member's identity has been obtained from the originating Member or the originating Member affirmatively elects to disclose its identity.

BeX would reveal the identity of a Member in the following circumstances: (1) for regulatory purposes or to comply with an order of a court or arbitrator; (2) when the National Securities Clearing Corporation ("NSCC") ceases to act for a Member or the Member's clearing firm, and NSCC determines not to guarantee the settlement of the Member's trades; (3) on risk management reports provided to the contra party of the Member or Member's clearing firm each day by 4:00 p.m. (E.S.T.) which disclose trading activity on the aggregate dollar value basis; or (4) unless otherwise instructed by a Member, BeX would reveal to a Member, no later than the end of the day on the date an anonymous trade was executed, when the Member's quote or order has been decremented by another quote or order submitted by that same Member.

To satisfy Members' recordkeeping obligations under Rules 17a-3(a)(1)<sup>23</sup> and 17a-4(a)<sup>24</sup> under the Act, the Exchange would retain for the period specified in Rule 17a-4(a) the identity of each Member that executes an anonymous transaction described Chapter XXXVII, Section 3(i)(iii) of the BSE Rules. BeX would retain information in its original form or a form approved under Rule 17a-6 under the Act.<sup>25</sup> Members would retain the obligation to comply with Rules 17a-3(a)(1) and 17a-4(a) under the Act whenever they possess the identity of their contra party.

The Commission believes that the proposed BSE rule relating to anonymity is appropriate in the context of the trading services proposed to be offered by BeX and is consistent with the

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<sup>23</sup> 17 CFR 240.17a-3(a)(1).

<sup>24</sup> 17 CFR 240.17a-4(a).

<sup>25</sup> 17 CFR 240.17a-6.

Act. The Commission notes that the proposed rule is consonant with the rules of other exchanges that the Commission previously has approved.<sup>26</sup>

#### **G. Market Makers**

BSE Members would be permitted to apply for Market Maker status.<sup>27</sup> An applicant would file an application for Market Maker status on a form prescribed by the Exchange. Applications would be reviewed by the Exchange, which would consider factors including, but not limited to, capital operations, personnel, technical resources, and disciplinary history. No Member would be permitted to act as a Market Maker in any security unless such Member had been approved as a Market Maker in a security by the Exchange pursuant to the BSE Rules and the Exchange had not suspended or canceled such approval. Approved Market Makers would be designated as dealers on the Exchange for all purposes under the Act and the rules and regulations thereunder.

An applicant's Market Maker status would become effective upon receipt by the Member of notice of an approval by the Exchange. In the event that an application was disapproved by the Exchange, the applicant would have an opportunity to be heard upon the specific grounds for the denial, in accordance with the provisions of Chapter XXX of the BSE Rules.

Market Maker status could be suspended or terminated by the Exchange upon a determination of any substantial or continued failure by such Market Maker to engage in dealings in accordance with the BSE Rules. Likewise, any Market Maker could withdraw its Market Maker status by giving written notice to the Exchange. Such withdrawal would become effective on the tenth business day following the Exchange's receipt of the notice. A Market

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<sup>26</sup> See, e.g., NYSE Arca Rule 7.41.

<sup>27</sup> See proposed Chapter XXXVII, Section 8 of the BSE Rules (Approval of Market Makers).

Maker who failed to give a ten-day written notice of withdrawal to the Exchange would be subject to formal disciplinary action pursuant to Chapter XXX of the BSE Rules. Subsequent to withdrawal, the Member would not be permitted to re-apply as a Market Maker for a period of six months.

A Market Maker would be assigned a newly authorized security or a security already admitted to dealings on the BeX by filing an assignment request form with the Exchange.<sup>28</sup> Assignment of the security would become effective on the first business day following the Exchange's approval of the assignment. In considering the approval of the assignment of the Market Maker in a security, the Exchange could consider: (1) the financial resources available to the Market Maker; (2) the Market Maker's experience, expertise and past performance in making markets, including the Market Maker's performance in other securities; (3) the Market Maker's operational capability; (4) the maintenance and enhancement of competition among Market Makers in each security in which they are assigned; (5) the existence of satisfactory arrangements for clearing the Market Maker's transactions; and (6) the character of the market for the security, e.g., price, volatility, and relative liquidity. A Market Maker's assignment in a security could be terminated by the Exchange if the Market Maker fails to enter quotations in the security within five business days after the Market Maker's assignment in the security becomes effective. Moreover, the Exchange could limit the number of Market Makers in a security upon prior written notice to Members.

Market Makers would be selected by the Exchange based on, but not limited to, the following: experience with making markets in equities; adequacy of capital; willingness to

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<sup>28</sup> See Chapter XXXVII, Section 9 of the BSE Rules (Assignment of Market Maker in a Security).

promote the BeX as a marketplace; issuer preference; operational capacity; support personnel; and history of adherence to Exchange rules and securities laws.

A Market Maker could voluntarily terminate its assignment in a security by providing the Exchange with a one-day written notice of such termination. A Market Maker that failed to give advanced written notice of termination to the Exchange could be subject to formal disciplinary action pursuant to Chapter XXX of the BSE Rules. Furthermore, the Exchange could suspend or terminate any assignment of a Market Maker in a security or securities whenever, in the Exchange's judgment, the interests of a fair and orderly market are best served by such action. A Member would be permitted to seek review of any action taken by the Exchange, including the denial of the application for, or the termination or suspension of, a Market Maker's assignment in a security or securities, in accordance with Chapter XXX of the BSE Rules.

Members assigned as Market Makers in one or more securities traded on the BeX would be required to engage in a course of dealings for their own account to assist in the maintenance, insofar as reasonably practicable, of fair and orderly markets on the BeX.<sup>29</sup> The responsibilities and duties of a Market Maker specifically would include, but not be limited to, the following: (1) maintaining continuous, two-sided quotes in those securities in which the Market Maker is assigned to trade; (2) maintaining adequate minimum capital in accordance with Rule 15(c)3-1 under Act;<sup>30</sup> (3) remaining in good standing with the Exchange; (4) informing the Exchange of any material change in financial or operational condition or in personnel; and (5) clearing and settling transactions through the facilities of a registered clearing agency. This last requirement could be satisfied by direct participation, use of direct clearing services, or by entry into a

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<sup>29</sup> See proposed Chapter XXXVII, Section 10 of the BSE Rules (Obligations of Market Makers).

<sup>30</sup> 17 CFR 240.15c3-1.



correspondent clearing arrangement with another Member that clears trades through such agency. A Market Maker would be required to satisfy the responsibilities and duties during BeX's primary trading session on all days in which the Exchange is open for business.

If the Exchange found any substantial or continued failure by a Market Maker to engage in a course of dealings as specified in the applicable BSE Rules, such Market Maker would be subject to disciplinary action or suspension or revocation of the assignment by the Exchange in one or more of the securities in which the Market Maker is assigned.

A Market Maker would be permitted to apply to the Exchange to withdraw temporarily from its Market Maker status in the securities in which it is assigned. The Market Maker would be required to base its request on demonstrated legal or regulatory requirements that necessitate its temporary withdrawal, or provide the Exchange an opinion of counsel certifying that such legal or regulatory basis exists. The Exchange would act promptly on such request and, if the request were granted, the Exchange could temporarily reassign the securities to another Market Maker.

Market Makers would be required to maintain minimum performance standards at levels determined from time to time by the Exchange. Such levels would vary depending on the price, liquidity, and volatility of the security in which the Market Maker is assigned. The performance measurements would include: (1) percent of time at the National Best Bid or National Best Offer; (2) percent of executions priced better than the National Best Bid or National Best Offer; (3) average displayed size; (4) average quoted spread; and (5) in the event the security is a derivative security, the ability of the Market Maker to transact in underlying markets.

A Market Maker on the Exchange would be permitted to engage in other business activities, or be affiliated with a broker-dealer that engages in Other Business Activities (as

defined below), only if there is an Information Barrier (also commonly referred to as “Chinese Wall”) between the market making activities and the other business activities.<sup>31</sup> “Other Business Activities” would mean: (1) conducting an investment banking or public securities business; or (2) making markets in the options overlying the security in which it makes markets.

The Exchange's proposed rule on limitations on dealings would require that market making functions be physically separated from the locations in which Other Business Activities are conducted. The proposal also would establish minimum requirements for the procedures to be implemented to prevent the use of material non-public corporate or market information in the possession of persons on one side of the barrier from influencing the conduct of persons on the barrier's other side. In addition, the proposal sets forth the items of information to be furnished in writing to the Exchange by the Member implementing an information barrier. Absent the Exchange finding a Member's information barriers acceptable, a Market Maker could not conduct Other Business Activities.

A Member or an affiliate of the Member would be permitted to clear the Member's Market Maker transactions if it establishes procedures to ensure that information with respect to such clearing activities will not be used to compromise the Information Barrier. In this regard: (1) the procedures must provide that any information pertaining to Market Maker securities positions and trading activities, and information derived from any clearing and margin financing arrangements, may be made available only to those employees (other than employees actually performing clearing and margin functions) specifically authorized under this Rule to have access to such information or to other employees in senior management positions who are involved in exercising general managerial oversight with respect to the market making activity; and (2) any

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<sup>31</sup> See proposed Chapter XXXVII, Section 11 of the BSE Rules (Limitations on Dealings).

margin financing arrangements must be sufficiently flexible so as not to limit the ability of any Market Maker to meet market making or other obligations under the Exchange's Rules.

The Commission believes that the Exchange's proposed rules regarding Market Makers for BeX are appropriate and consistent with the Act. The Commission notes that the Exchange's rules are substantially similar to rules of other exchanges that it has previously approved.<sup>32</sup>

#### **H. Application of “Effect v. Execute” Exemption from Section 11(a) of the Act**

When the Commission approved BeX Phase I,<sup>33</sup> the Commission found, based upon representations made by the Exchange,<sup>34</sup> that BeX Phase I satisfied the requirements of Rule 11a2-2(T)<sup>35</sup> under Section 11(a) of the Act.<sup>36</sup> With respect to Rule 11a2-2(T)'s off-floor requirement,<sup>37</sup> the Commission found that orders sent, by electronic means, from the Exchange's physical trading floor could be considered to be sent from “off-floor” for purposes of the BeX trading system.<sup>38</sup> In reaching this conclusion, the Commission relied, among other things, upon the Exchange's statement that securities traded on the BeX trading system would not be traded on the Exchange's physical floor and, therefore, the BeX trading system could be considered essentially a different, separate “trading floor.”<sup>39</sup>

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<sup>32</sup> See, e.g., NYSE Arca Rule 7.26.

<sup>33</sup> See BeX Phase I Order, *supra* note 6.

<sup>34</sup> See Letter from William C. Meehan, General Counsel, BSE, to Kelly M. Riley, Assistant Director, Division of Market Regulation, Commission, dated June 2, 2006; Letter from William C. Meehan, General Counsel, BSE, to Kelly M. Riley, Assistant Director, Division, Commission, dated August 8, 2006.

<sup>35</sup> 17 CFR 240.11a2-2(T).

<sup>36</sup> 15 U.S.C. 78k(a).

<sup>37</sup> See 17 CFR 240.11a2-2(T)(a)(2)(ii).

<sup>38</sup> See BeX Phase I Order, *supra* note 6, at 52197.

<sup>39</sup> See *id.* In the BeX Phase I Order, the Commission also noted that Exchange members on the Exchange's physical trading floor would not have a time/place advantage with regard

In connection with the proposed rule change to implement BeX Phase II, the Exchange updated certain representations it made to the Commission to reflect changes being made in BeX Phase II. Specifically, the Exchange stated that upon implementation of BeX Phase II, all transactions on the Exchange will take place within the BeX electronic trading facility, and the Exchange's physical trading floor will cease to exist. Accordingly, the Exchange has represented that in BeX Phase II, all orders for the accounts of Exchange members will be transmitted to the BeX trading system from off the floor (since the Exchange no longer will have any physical trading floor) by electronic means.<sup>40</sup> The Exchange has stated that, other than the elimination of the physical trading floor, all of the other representations it made to the Commission in connection with BeX Phase I remain true and correct in all respects for BeX Phase II.<sup>41</sup> Therefore, the Commission believes that BeX Phase II satisfies the requirements of Rule 11a2-2(T).

## **I. Regulation NMS**

### **1. Locking and Crossing Quotations in NMS Stocks**

In accordance with the requirements of Rule 610 of Regulation NMS, BSE Members would have an obligation to reasonably avoid displaying, and avoid engaging in a pattern or practice of displaying any quotations that lock or cross a protected quotation, and any manual quotations that lock or cross a quotation previously disseminated pursuant to an effective national market system plan. This rule would be contained in new Chapter XXXVIII, Section 2 of the BSE Rules. The proposed rule states that it will not become effective until February 5, 2007, or an earlier appropriate

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to the securities traded in the BeX trading system, and that members present on the Exchange's physical trading floor would see information about orders at the top of the BeX trading system only after that information had been sent to the securities information processor for dissemination to the public.

<sup>40</sup> See Amendment No. 2.

<sup>41</sup> See id.

exemption from the ITS Plan is obtained.

For purposes of this proposed rule, a “crossing quotation” would mean the display of a bid for an NMS stock during regular trading hours at a price that is higher than the price of an offer for such NMS stock previously disseminated pursuant to an effective national market system plan, or the display of an offer for a NMS stock during regular trading hours at a price that is lower than the price of a bid for such NMS stock previously disseminated pursuant to an effective national market system plan. For purposes of this proposed rule, a “locking quotation” would mean the display of a bid for an NMS stock during regular trading hours at a price that equals the price of an offer for such NMS stock previously disseminated pursuant to an effective national market system plan, or the display of an offer for a NMS stock during regular trading hours at a price that equals the price of a bid for such NMS stock previously disseminated pursuant to an effective national market system plan.

The proposed rule would provide four exceptions from the prohibition on locking or crossing protected quotations. The proposed rule would except: (1) those quotations displayed at a time when the Trading Center displaying the locked or crossed quotation was experiencing a failure, material delay or malfunction of its systems or equipment; (2) those quotations displayed at a time when the protected bid was higher than a protected offer in the NMS stock; (3) those automated quotations where the BSE member displaying such automated quotation simultaneously routed an ISO order to execute against the full displayed size of any locked or crossed protected quotation; and (4) those manual quotations that locked or crossed another manual quotation, and the BSE member displaying the locking or crossing manual quotation simultaneously routed an ISO to execute against the full displayed size of the locked or crossed manual quotation.

The Commission believes that the proposed rule on locking or crossing quotations is

consistent with Rule 610(d) of Regulation NMS.

## **2. Order Routing**

The BSE has proposed a rule, in accordance with the requirements of Regulation NMS, that would govern the order routing process.<sup>42</sup>

The BSE would only route an eligible order when the order has not been executed in its entirety on BeX due to the requirements of Chapter XXXVIII, Section 4, paragraph (a) of the BSE Rules, consistent with Rule 611 of Regulation NMS, and the terms of the order permit routing to another Trading Center for execution. The BSE has determined that eligible orders would be orders that are designated by the customer to execute or route. IOC, AIOC, all ISO order types and FOK orders would not be designated to execute or route.

Orders would be routed either in their entirety or as component orders to an away Trading Center(s). Orders would be routed, consistent with Rule 611 of Regulation NMS, to the Trading Center(s) publishing any better-priced Protected Bid(s) or Protected Offer(s) for execution against such Protected Bid(s) or Protected Offer(s) for the full displayed size of the Protected Quotation. The remaining portion of the order, if any, will be executed, or ranked and displayed on the BSE book, in accordance with the terms of such order and would be handled in the manner described in Chapter XXXVII, Section 3 of the BSE Rules.

Eligible orders would be routed on behalf of the Member who submitted the eligible order if that Member is a member or subscriber of the away Trading Center or, in the case where the Member is not a member or subscriber of the away Trading Center, the order would be routed through a third party broker-dealer, or “give up,” that is a member or subscriber of the away Trading Center pursuant to the terms of an agreement entered into between the BSE and that third party

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<sup>42</sup> See Chapter XXXVIII, Section 3 of the BSE Rules (Order Routing).

broker-dealer, which agreement is described below. The eligible order would be routed to another Trading Center priced at the Protected Quote published by the Trading Center.

As stated above, the Exchange would route orders to other Trading Centers under certain circumstances (“Routing Services”). The Exchange would provide its Routing Services pursuant to the terms of three separate agreements: (1) an agreement between the Exchange and each Member on whose behalf orders would be routed (“Member-Exchange Agreement”); (2) an agreement between the Exchange and each third-party broker-dealer that would serve as a “give-up” on an away Trading Center when the Member on whose behalf an order is routed is not also a member or subscriber of the away Trading Center (“Give-Up Agreement”); and (3) an agreement between the Exchange and a third-party service provider (“Technology Provider”) pursuant to which the Exchange licenses the routing technology used by the Exchange for its Routing Services (“Exchange-Technology Provider Agreement”).

The Exchange would provide its Routing Services in compliance with these rules and with the provisions of the Act and the rules thereunder, including, but not limited to, the requirements in Sections 6(b)(4) and (5) of the Act<sup>43</sup> that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

As provider of the Routing Services, the Exchange would license the necessary routing technology for use within its own systems and accordingly would control the logic that determines when, how, and where orders are routed away to other Trading Centers.

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<sup>43</sup> 15 U.S.C. 78f(b)(4) and (5).

The Exchange would establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange (including its facilities) and the Technology Provider, and, to the extent the Technology Provider reasonably receives confidential and proprietary information, that adequately restrict the use of such information by the Technology Provider to legitimate business purposes necessary for the licensing of routing technology. The Exchange-Technology Provider Agreement would include terms and conditions that enable the Exchange to comply with these proposed requirements.

As noted above, if an order that is eligible for routing cannot be executed in its entirety on the BSE, consistent with the requirements of Rule 611 of Regulation NMS, the order would be routed to the applicable Trading Center(s). While an order remains outside the BSE, it would have no time standing relative to others received from BSE Members at the same price that could be executed against interest on the BSE book. Requests from BSE Members to cancel their orders while routed away to another Trading Center would be processed subject to applicable trading rules of the relevant away Trading Center. Where an order is not fully executed at the away Trading Center(s), the order would be executed, or ranked and displayed on the BSE book in accordance with the terms of such order and would be handled in the manner described in Chapter XXXVII, Section 3 of the BSE Rules.

The Commission finds that the Exchange's proposal to provide outbound Routing Services, and the proposed rules governing such services, are consistent with the Act. The Commission notes that the Exchange's proposed outbound routing functionality is not the exclusive means for accessing better priced quotes in other market centers, should an order not be executable on the BeX facility. Accordingly, the Exchange's Routing Services are optional, and a Member is free to route



its orders to other market centers through alternative means.

### **3. Order Protection Requirements Rule**

The BSE, in accordance with the requirements of Regulation NMS, has proposed an order protection requirements rule that would prohibit trades from being executed on the BSE if the execution would result in an improper trade-through under Rule 611 of Regulation NMS.<sup>44</sup> If the execution of an order on the Exchange would cause an improper trade-through, that order, if eligible to route, would be routed to the appropriate Trading Center(s) or, if not, automatically cancelled. The proposed rule states that it will not become effective until February 5, 2007.

The proposed order protection requirements rule would contain several exceptions that are exceptions under Rule 611 of Regulation NMS, including: a crossed markets exception, a self-help exception, a non-regular way cross exception, a single priced opening, reopening or closing trade exception, an inbound ISO exception, a stop order exception, and an exception for a benchmark order executed at the BSE.<sup>45</sup> In addition, the BSE would be able to disregard the bid or offer of a Trading Center if it is identified by the Trading Center a manual quotation. If a purchase or sale of an NMS stock qualifies for an exception to the Order Protection Rule under Regulation NMS, the BSE would attach an appropriate modifier approved by the operating committee of the relevant national market system plan.<sup>46</sup>

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<sup>44</sup> See proposed Chapter XXXVIII, Section 4 of the BSE Rules (“Order Protection Requirements”). Under the proposed rule, an order would not be eligible for execution on the BSE if its execution is at a price that is lower than a Protected Bid or higher than a Protected Offer (a “trade-through”), or if its execution would be improper under Rule 611 of Regulation NMS (together, an “improper trade-through”).

<sup>45</sup> According to the Exchange, BeX does not presently provide for non-regular way cross orders or benchmark orders, although these order types may be introduced in the future through an appropriate proposed rule change to be filed with the Commission.

<sup>46</sup> If a trade is executed pursuant to the ISO exception of Rule 611(b)(5) or (6) and the self-help exception of Rule 611(b)(1), the trade will be identified as executed pursuant to the ISO exception.

The Exchange represents that it intends to operate as an automated trading system that displays bids and offers that qualify as automated quotations under the definition set out in Rule 600(b)(3) of Regulation NMS, with manual capabilities in the event it is unable to generate automated quotations. Among other things, if the BSE has not accepted two or more AIOC orders sent as sequential test messages, the BSE would attach a “manual” identifier to the bids and offers it makes publicly available. Additionally, immediately upon receiving an alert as a result of its periodic processes that the Exchange’s trading system has taken more than two seconds to process two or more AIOC orders in a symbol sent as sequential messages, the Market Operations Center (“MOC”) would automatically attach a “manual” identifier to the bids and offers it makes publicly available.

Once the BSE has made any required systems changes, or otherwise determined that its quotations satisfied the requirements of Rule 600(b)(3) of Regulation NMS, and conducted applicable tests to confirm that the Exchange’s quotes qualify as automated quotations, the Exchange would remove the “manual” identifier from the bids and offers that are made publicly available. The Exchange also would notify other Trading Centers that its quotations are automated by announcing that fact through an appropriate mechanism for communicating with other Trading Centers.

The Commission believes that the Exchange’s rules governing order protection requirements are consistent with Rule 611 of Regulation NMS.

#### **IV. Accelerated Approval of Amendment No. 2**

The Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after publishing notice of Amendment No. 2 in the Federal

Register pursuant to Section 19(b)(2) of the Act.<sup>47</sup>

In Amendment No. 2, the Exchange: (1) introduced a new order type to be known as a non-displayed order; (2) amended the definition of a preferred price cross and ISO cross; (3) clarified when certain provisions related to Regulation NMS become effective; (4) added provisions for the handling of odd-lot and mixed-lot orders, including the ranking and display of odd-lots and mixed-lots; (5) clarified the ranking and display of Reserve Orders; (6) added a provision relating to the anonymity of trades executed by a Member against itself; (7) added a provision relating to access to BeX by Sponsored Participants; (8) stating that, for purposes of Section 11(a) of the Act (15 U.S.C. 78k(a)) and Rule 11a2-2(T) (17 CFR 240.11a2-2(T)) thereunder, all orders for the accounts of Exchange members will be transmitted to the BeX trading system from off the floor (since the Exchange no longer will have any physical trading floor) by electronic means; and (9) making several clarifying changes and correcting several technical errors contained in the rule text.

The Commission notes that the proposal to amend the definition of a preferred price cross order to require it to execute at better than the best bid and offer displayed on BeX and equal to or better than the National Best Bid or National Best Offer is a clarifying change that comports with the requirements for cross orders on BeX previously approved by the Commission.<sup>48</sup>

Amendment No. 2 made a similar change with respect to the definition of an ISO cross order.

The Commission further notes that other exchanges have rules in place similar to the rules proposed by the Exchange relating to non-displayed orders, odd-lot and mixed-lot orders, anonymity of trades executed by a Member against itself, and access by Sponsored Participants.

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<sup>47</sup> 15 U.S.C. 78s(b)(2).

<sup>48</sup> See note 6 supra.

Finally, Amendment No. 2 contains several clarifying and technical changes that do not affect the substance of the proposed rule change.

Accordingly, the Commission believes that accelerating approval of Amendment No. 2 raises no new or novel issues of regulatory concern and therefore the Commission believes its implementation should not be delayed. The Commission also believes that accelerated approval is reasonable because it should help to ensure that the appropriate rules are in place at the Exchange at the time that the BSE's final technical specifications with respect to Regulation NMS must be published. Further, the Exchange's representation with respect to the applicability of Rule 11a2-2(T) to trading on BeX simply updates a representation previously provided to the Commission.

For the reasons noted above, the Commission finds good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after publishing notice of Amendment No. 2 in the Federal Register pursuant to Section 19(b)(2) of the Act.<sup>49</sup>

## **V. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 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-2006-30 on the subject line.

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<sup>49</sup> 15 U.S.C. 78s(b)(2). Pursuant to Section 19(b)(2) of the Act, the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission finds good cause for

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-BSE-2006-30. 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 Room. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. 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 Amendment No. 2 of File Number SR-BSE-2006-30 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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so doing.

## VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5) of the Act.<sup>50</sup>

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>51</sup> that the proposed rule change (SR-BSE-2006-30) is approved and Amendment No. 2 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>52</sup>

Nancy M. Morris  
Secretary

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<sup>50</sup> 15 U.S.C. 78f(b)(5).

<sup>51</sup> 15 U.S.C. 78s(b)(2).

<sup>52</sup> 17 CFR 200.30-3(a)(12).