and near neighbor[11] objective measures of specialist performance.

The Exchange proposes to amend the Allocation Policy to limit the weight that the SPEQ may be given in the allocation decision making process to no more than 25%. Currently, the Policy permits the Allocation Committee to grant up to one-third weight to SPEQ results in its allocation decisions.

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b)(5) of the Act.[12] Section 6(b)(5) requires that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest. Further, the Commission finds that the proposal is consistent with Section 11(b) of the Act[13] and Rule 11b–1 thereunder,[14] which allow exchanges to promulgate rules relating to specialists to ensure fair and orderly markets. For the reasons set forth below, the Commission believes that limiting the weight given the SPEQ should enhance the Exchange's allocation process and encourage improved specialist performance, consistent with the protection of investors and the public interest.

Specialists play a crucial role in providing stability, liquidity and continuity to the trading of securities. Among the obligations imposed upon specialists by the Exchange, and by the Act and the rules thereunder, is the maintenance of fair and orderly markets in their designated securities.[15] To ensure that specialists fulfill these obligations, it is important that the Exchange develop and maintain stock allocation procedures and policies that provide specialists with an initiative to strive for optimal performance.

Although the SPEQ remains a useful tool to measure performance, the Commission has long believed that objective indications of performance should play an important role in allocation decisions. In particular, the Commission believes that objective performance measures can identify poor market making performance that otherwise may not be reflected in a unit's SPEQ survey results. In this regard, the Commission notes that the Exchange has initiated, on a pilot basis, the capital utilization and near neighbor programs. In light of these additional objective measures of specialist performance, the Commission believes that it is appropriate to limit the weight that the SPEQ may be given in allocation decisions to one quarter, thereby increasing the emphasis given to objective measures of performance. In addition, the Commission notes that a reduction in the weight given the SPEQ from one-third to 25% is relatively minor, especially given the additional objective measures to be consider by the Allocation Committee. Nevertheless, to the extent that the near neighbor and capital utilization measures are only adopted on a pilot basis, if those measure are not extended or permanently approved, the Commission would expect the NYSE to re-evaluate the Allocation Policy to ensure there are adequate indicia of performance being considered by the Allocation Committee.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[16] that the proposed rule change (SR–NYSE–95–06) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[17]

Jonathan G. Katz,

Secretary.

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utilization program pilot so that the Exchange and the Commission may evaluate the capital utilization and near neighbor programs concurrently. *See* Securities Exchange Act Release No. 35926 (June 30, 1995) (extending pilot through September 10, 1996).

[11] The near neighbor approach to evaluating specialist performance compares the performance in a stock over rolling three-month periods to the performance of stocks with similar trading characteristics. The Commission approved the near neighbor program on a pilot basis in Securities Exchange Act Release No. 35927 (June 30, 1995).

[12] 15 U.S.C. 78f(b)(5) (1988).

[13] 15 U.S.C. 78k(b) (1988).

[14] 17 CFR 240.11b–1 (1994).

[15] *See* 17 CFR 240.11b–1 (1994); NYSE Rule 104.

[16] 15 U.S.C. 78s(b)(2) (1988).

[17] 17 CFR 200.30–3(a)(2) (1984).

[Release No. 34–35927; File No. SR–NYSE–95–05]

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change Relating to Near Neighbor Approach to Measuring Specialist Performance

June 30, 1995.

I. Introduction

On February 28, 1995, the New York Stock Exchange, Inc. (''NYSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change to adopt a new approach to measuring specialist performance that would be used in allocation decisions and modify an existing measure of specialist performance.

The proposed rule change was published for comment in Securities Exchange Act Release No. 35661 (May 2, 1995), 60 FR 22593 (May 8, 1995). No comments were received on the proposal.

II. Description

The NYSE proposes to adopt, on a pilot basis, the near neighbor measure of specialist performance to be considered by the Allocation Committee in allocating stocks to specialist units.[3] The Exchange also proposes some modifications to its existing capital utilization measure, which is currently used by the Allocation Committee on a pilot basis.[4]

The near neighbor measure compares the performance in a stock over ''rolling'' three-month periods to the performance of stocks with similar trading characteristics (''near neighbors''). The near neighbor program analyzes the following market quality measures: (1) Continuity, which is the

[1] 15 U.S.C. 78s(b)(1) (1988).

[2] 17 CFR 240.19b–4 (1994).

[3] The Exchange's Allocation Policy and Procedures governs the allocation of equity securities to NYSE specialist units. The Allocation Committee has sole responsibility for the allocation of securities to specialist units pursuant to Board-delegated authority, and is overseen by the Quality of Markets Committee of the Board of Directors. The Allocation Committee renders decisions based upon the allocation criteria specified in the Allocation Policy. The Allocation Policy states that the Allocation Committee will base its allocation decisions on the Specialist Performance Evaluation Questionnaire (''SPEQ''), objective performance measures, and the Committee's expert professional judgment. *See also* note 13, *infra*. The Allocation Committee currently considers the capital utilization measure, in addition to several other objective performance measures. *See, e.g.*, Securities Exchange Act Release No. 35927 (June 30, 1995) (discussing NYSE Allocation Policy and Procedures).

[4] The specialist capital utilization program measures the dollar value of a specialist's proprietary trading in relation to the total dollar value of shares traded in the specialist's stocks. The Commission approved the capital utilization measure on a one-year pilot basis in Securities Exchange Act Release No. 33369 (December 23, 1993), 58 FR 69431 (December 30, 1993). The Commission approved a six-month extension to the pilot program in Securities Exchange Act Release No. 35175 (December 29, 1994), 60 FR 2167 (January 6, 1995) (extending pilot through June 30, 1995). The Commission has extended the capital utilization program pilot so that the Exchange and the Commission may evaluate the captital utilization and near neighbor programs concurrently. *See* Securities Exchange Act Release No. 35926 (June 30, 1995) (extending pilot through September 10, 1996).

change in price from trade to trade;[5] (2) market depth, which is the maximum price change over a 3000-share sequence of trades;[6] (3) quotation spread, which is the difference between the bid price and the ask price;[7] and (4) specialist capital utilization.[8]

Stocks will be separated into three broad categories: (1) Stocks in the top 200 stocks in the S&P 500 Stock Index and other stocks that are as active; (2) the remaining component stocks of the S&P 500 Index and stocks among the 500 most active stocks on the Exchange; and (3) all other stocks. The following stocks will be excluded from the near neighbor analysis: Foreign stocks, preferred stocks, warrants, when issued stocks, IPOs (for the first 60 days), closed-end funds, stocks selling for $5 and under, stocks with less than 2,000 shares average daily trading volume, stocks with two classes of shares, merger/acquisition stocks if there was a significant impact on the price or volume, and stocks that have been delisted for more than half of the examination period.[9]

Each month, each specialist units' eligible stocks are classified as belonging to one of the three broad categories noted above. A determination is then made for each individual stock (the ''target stock'') as to which other stocks are statistically similar to it (its ''near neighbors''), based on certain market characteristics. The characteristics that are used in this determination are price, non-block volume, daily high low range, and the dollar value of the stock's ''float'' (*i.e.*, shares that are available for trading that are not closely held).[10] A statistical formula is applied to each stock's four market characteristics to determine its statistical ''distance'' from the target stock. Stocks with distances of 1.000 or less are considered to be ''near neighbors'' of the target stock. Stocks with distances greater than 1.000 are considered to be too different to be considered ''near neighbors'' of the target stock.[11]

For all stocks with three or more near neighbors, a single weighted[12] average performance percentage combining the results for all the near neighbors is calculated for each market quality measure. Then, using statistical techniques involving standard deviations, each target stock's actual performance in the market quality measures listed above is compared to the combined performance of its near neighbors.

When a comparison with its near neighbors is made, the target stock is then placed into one of three groups: a stock whose performance is statistically poorer than the mean performance of the near neighbor stocks is classified in the ''Below Mean'' group; a stock whose performance is statistically similar to the mean performance is classified in the ''Mean'' group; and a stock whose performance is statistically better than the mean is classified in the ''Above Mean'' group. Stocks that have fewer than three near neighbors are automatically classified in the ''Mean'' group. An additional analysis is performed on the stocks in the ''Mean'' group to highlight those stocks that have relatively high performance even though that performance is statistically similar to the calculated average of their near neighbors. A ''Mean'' group stock will be considered to have relatively high performance if its performance percentage is in the top quartile of all stocks in its stock category (*i.e.*, top 200, next 300, or other).

Each specialist unit will receive three reports each month containing the results of the near neighbor analyses for the most recent three-month period. These will include: (1) A Stock Detail Report for each stock that provides market data and performance information about the stock and each of the other stocks that were identified as its ''near neighbors,'' (2) a Stock Summary Report that lists each stock and provides data on the performance of the target stock and the average performance of its near neighbors, as well as whether the target stock's performance is ''Below Mean,'' ''Mean,'' or ''Above Mean,'' for each performance measure, and (3) a Specialist Unit Summary Report that shows, for each performance measure and within each stock category, the number of stocks that are in each group classification, and the percentage of the unit's total stocks that are in each group classification. The Unit Summary Report also shows the percentage of the unit's ''Mean'' group stocks that had high performance percentages.

The Allocation Committee will receive only the summary data appearing on the Specialist Unit Summary Report, which will be updated each month (covering the three most recent months) upon the distribution of the reports to the specialist units. The Allocation Committee will not receive near neighbor performance data for individual stocks. The Allocation Committee also will receive a list of each unit's stocks that had fewer than three near neighbors and were automatically classified in the ''Mean'' group. Included with each stock will be its percentage of the unit's total dollar value of shares traded.

The Exchange also is modifying the specialist capital utilization performance measure to ensure commonality between it and the near neighbor program as follows: (1) Exclusion of stocks with two classes of shares (*e.g.*, Class A & Class B), ''merger/acquisition'' stocks if there was a significant impact on the price or volume, and stocks that have been delisted for more than half of the examination period; and (2) reduction of the performance review period for measuring capital utilization from a rolling 12 months to a rolling three months.[13]

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder

[5] Continuity is measured by the percentage of trades with a change of ⅛th point or less from the previous trade.

[6] Depth is measured by the percentage of depth sequences with a high/low range of ⅛ point or less.

[7] Spread is measured by the percentage of reported quotations with a spread of ¼ point or less.

[8] A capital utilization percentage is derived for each specialist unit by dividing the average daily dollar value of the unit's stabilizing purchases and sales by the average daily total dollar value of shares traded in the unit's stocks. Capital utilization is measured two ways: (1) using stabilizing dealer volume; and (2) using stabilizing plus reliquifying dealer volume.

[9] *See* letter from Daniel Pucker Odell, NYSE, to Katherine Simmons, SEC, dated June 30, 1995 (excluding stocks that have been delisted for more than half the examination.

[10] A stock will be considered ''similar'' to a target stock if: (1) the median average daily price is within 30% of a target stock under $20, or within $6 of a target stock between $20 and $60, or within 10% of a target stock above $60; (2) the median daily non-block volume (*i.e.*, trades under 25,000 shares) is within 30% of the target stock; (3) the median daily high-low range equals the median high-low range of the target stock +/−7.5% of:

i. 30% of the price for a target stock under $20,

ii. $6 for a target stock between $20 and $60,

iii. 10% of the price for a target stock above $60 and (4) the market value of the float is within 30% of the target stock.

[11] If there are more than 20 stocks with distances of 1.000 or less, only the 20 stocks that are closest to the target stock are used in the analysis.

[12] The weight of a near neighbor stock decreases as its distance from the target stock increases. If a stock's distance from the target stock is less than 0.500, then its weight is 1.000. If a stock's distance from the target stock is greater than 0.500, then its weight is less than 1.000.

[13] The Commission also has approved an NYSE proposal to reduce the weight given in the allocation decision making process to the Specialist Performance Evaluation Questionnaire from ⅓ to ¼ in recognition of the Exchange's adoption for allocation decision purposes of the near neighbor and capital utilization objective measures. *See* Securities Exchange Act Release No. 35932 (June 30, 1995).

applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b)(5) of the Act.[14] Section 6(b)(5) requires that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest. Further, the Commission finds that the proposal is consistent with Section 11(b) of the Act[15] and Rule 11b–1 thereunder,[16] which allow exchanges to promulgate rules relating to specialists to ensure fair and orderly markets. For the reasons set forth below, the Commission believes that the consideration of the near neighbor analysis by the Allocation Committee should enhance the Exchange's allocation process and encourage improved specialist performance, consistent with the protection of investors and the public interest.

Specialists play a crucial role in providing stability, liquidity and continuity to the trading of securities. Among the obligations imposed upon specialists by the Exchange, and by the Act and rules thereunder, is the maintenance of fair and orderly markets in designated securities.[17] To ensure that specialists fulfill these obligations, it is important that the Exchange develop objective measures of specialist performance and prescribe stock allocation procedures and policies that encourage specialists to strive for optimal performance. The Commission supports the NYSE's effort to develop the near neighbor measure to encourage improved specialist performance and market quality.

The Commission believes that the near neighbor measure should provide the NYSE Allocation Committee with an objective measure of specialist performance that will refine the Exchange's allocation process. The NYSE's Allocation Policy emphasizes that the most significant allocation criterion is specialist performance. In the Commission's view, performance based stock allocations not only help to ensure that stocks are allocated to specialists who will make the best markets, but will provide an incentive for specialists to improve their performance or maintain superior performance.

The Commission believes that the near neighbor measure, which compares a specialist's performance in an issue to the performance of other stocks with similar trading characteristics,[18] has the potential to be a significant advance in the NYSE's evaluation of a specialist's market making. The near neighbor program analyzes four market quality measures: continuity, market depth, quotation spread, and capital utilization. The Commission believes these market quality measures identify aspects of market making that are directly relevant to the specialist's maintenance of fair and orderly markets. Thus, the Commission believes that the near neighbor approach could aide the Allocation Committee in allocating stocks to specialists who commit their own capital to maintain stable and liquid markets.

Finally, the Commission believes that it is appropriate for the NYSE to implement the near neighbor measure on a pilot basis until September 10, 1996. A pilot will provide the Exchange and the Commission with an opportunity to study the effects of the use of the measure on the NYSE's allocation process. The Commission also has approved an extension of the NYSE's specialist capital utilization measure so that the two objective measures can be evaluated simultaneously.[19] During the pilot period, the Commission expects the NYSE to monitor carefully the effects of the near neighbor and capital utilization programs and report its findings to the Commission. Specifically, the Commission requests that the NYSE report the near neighbor and capital utilization data as presented to the Allocation Committee. In addition, the Exchange should, for a three month sample period,[20] submit a report that identifies the specialist units, the securities for which they applied, the stocks that were allocated to them, and the specialist units' SPEQ ratings as presented to the Allocation Committee.[21] In the report, the Exchange should identify allocations that were made to specialist units with relatively poor tier ratings in the objective measures and discuss the reasons the Allocation Committee made such allocations.[22] Because near neighbor also measures, among other things, capital utilization, the Exchange also should address in its report how the two measures work together and whether there is a need for a separate capital utilization standard if they determine to continue the near neighbor measure.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[23] that the proposed rule change (SR–NYSE–95–05) is approved through September 10, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[24]

Jonathan G. Katz,

Secretary.

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[14] 15 U.S.C. 78f(b)(5) (1988).

[15] 15 U.S.C. 78k(b) (1988).

[16] 17 CFR 240.11b–1 (1994).

[17] *See, e.g.,* 17 CFR 240.11b–1 (1994); NYSE Rule 104.

[18] The NYSE believes preliminarily that the stocks being excluded from the near neighbor measure do not lend themselves to comparison with other stocks and therefore could tend to inappropriately affect the results obtained from the analysis. The Commission therefore believes that it is appropriate that the Exchange also exclude the securities from the capital utilization program, which reports to the Allocation Committee a specialist unit's commitment of capital relative to other specialist units. As the NYSE gains experience with the near neighbor approach, it should evaluate whether some categories of the excluded stocks can be included in the programs in order to expand the universe of stocks being examined via these approaches.

[19] *See supra* note 4. The Commission recently extended the Exchange's Rule 103A pilot program so that it would run concurrently with the near neighbor and capital utilization pilot programs. *See* Securities Exchange Act Release No. 35704 (May 10, 1995), 60 FR 26060 (May 16, 1995). Rule 103A grants authority to the Exchange's Market Performance Committee to develop and administer systems and procedures, including the determination of appropriate standards and measurements of performance, designed to measure specialist performance and market quality on a periodic basis to determine whether or not particular specialist units need to take actions to improve their performance. The Commission emphasized in the extension order its belief that objective measures of specialist performance should be incorporated into the evaluation process. During the pilot period, the Market Performance Committee will receive quarterly reports on the near neighbor initiative, with a view toward their recommending such enhancements or modifications as may seem appropriate based on actual experience with the measure. The Commission believes that the Exchange should have sufficient experience with the capital utilization and near neighbor measures of specialist performance at the end of the pilot period to judge whether these objective measures should be incorporated into the Rule 103A evaluation criteria.

[20] This sample period shall be January 1, 1996, through March 31, 1996.

[21] The Commission believes that this information will allow it to evaluate to the extent to which the Allocation Committee's decisions appear consistent with the relative performance of specialist units according to the objective measures. In this regard, however, the Commission recognizes that the Allocation Committee also considers the SPEQ results and may use its professional judgment in making allocation decisions. *See supra* note 12.

[22] The Exchange may submit one report for both the near neighbor and capital utilization pilots. This report should be submitted to the Commission by May 15, 1996, along with the Exchange's request for permanent approval or extension of the pilot programs.

[23] 15 U.S.C. 78s(b)(2) (1988).

[24] 17 CFR 200.30–3(a)(12) (1994).