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

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

VII. Conclusion

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

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

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

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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

BILLING CODE 8010–01–M

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

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

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

March 29, 1996.

I. Introduction

On March 1, 1995, The Cincinnati Stock Exchange (''CSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to adopt permanently the Exchange rules governing preferenced trading. On August 11, 1995, the Exchange submitted Amendment No. 1 to the proposed rule change to adopt order handling policies for preferencing dealers.

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

II. Background

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

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

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

[2] 17 CFR 240.19b–4.

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

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

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

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

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

[8] T3Id.

market makers on the Exchange.[9] Thus, the CSE believed that altering the priority rules between professional trading interests was necessary to bring the CSE dealers on par with other regional specialists and consequently attract retail order flow and enhance liquidity and efficiency on the Exchange. At the same time, the CSE continued to protect customer orders on the Exchange's central limit order book by requiring that such limit orders be satisfied before a dealer could internalize same-priced customer orders and by ensuring that internalized orders be executed at no worse than the national best bid or offer.[10]

In approving the initial pilot program, the Commission stated that the proposal addressed the CSE's legitimate desire to attract additional business to the Exchange, while at the same time providing adequate protection for public agency orders placed on the Exchange's central limit order book.[11] The Commission noted that the CSE combines features of both exchange and over-the-counter markets.[12]

During the course of the DPP pilot the Commission has been considering whether preferencing and the increasing internalization of order flow, and practices such as payment for order flow, are consistent with a broker-dealer's duty to seek best execution for customer orders. Consistent with its consideration of payment for order flow and best execution, the Commission requested that the CSE start providing data to show the effects of preferencing on the quality of order execution and market making on the CSE.[13] At the same time, the Commission approved, on a pilot basis, a competing specialist program on the Boston Stock Exchange (''BSE''), which also raised issues regarding internalization of order flow.[14]

In addition, in October 1994, the Commission adopted rules concerning the disclosure of payment for order flow practices and the order routing arrangements of broker-dealers receiving payment for order flow.[15] The Commission noted that not all market centers expose market orders to other order flow or provide an opportunity for price improvement for market orders. While price improvement was not the exclusive factor for determining whether a broker-dealer was fulfilling its duty to seek best execution, the Commission believed it important to the inquiry, particularly when payment was received by the broker-dealer, or when the broker-dealer internalized orders or routed orders to affiliates.[16]

III. Description

The Exchange requests permanent approval of its DPP. In conjunction with its permanent approval request, the CSE also seeks approval of rule changes implementing new order handling policies for the purpose of increasing order exposure and ensuring the timely execution and display of limit orders on the CSE.

A. Dealer Preferencing

The preferencing program permits CSE dealers to retain and execute their internal order flow at the prevailing ITS best bid or offer (''ITS/BBO''), provided that there are no public agency limit orders on the Exchange's central limit order book at that price or better. To this end, the preferencing program permits CSE dealers to internalize order flow by eliminating time priority between CSE dealers, thereby enabling preferencing dealers to interact with public market and marketable limit orders they represent as agent. Specifically, the preferencing program gives preferencing dealers priority over professional agency or principal orders entered prior in time when interacting with a public order it represents as agent.[17] The dealer may interact with such orders either by (1) taking the contra-side of the trade as principal (''paired order trade''), or (2) crossing the order with another customer order it represents as agent (''agency cross'').[18]

For example, if dealer A on the CSE is quoting at the ITS/BBO, dealer B can still internalize its order flow (even if it is not quoting at the ITS/BBO) so long as dealer B executes the order at the ITS/BBO (or better) and there is no contra-side public agency order on the CSE's central limit order book at that price. If there is a public agency limit order on the CSE's book with priority, however, NSTS will automatically break the paired order trade and match the incoming public agency order with the public limit order on the CSE's book.[19]

As noted above, in approving the initial DPP pilot, and subsequent extensions and expansions, the Commission imposed certain limitations and requirements on its operation. These conditions currently limit the number of issues in which a preferencing dealer may be registered to 350; prohibit preferenced trading for index arbitrage purposes when certain ''circuit breakers'' are in effect;[20] and prohibit a dealer from making cash payments for preferenced order flow. In connection with its request for permanent approval of the DPP, the Exchange requests that the Commission remove the limitation on the number of stocks preferencing dealers may trade and the prohibition on cash payments for order flow.

B. Order Handling Policies for Preferencing Dealers

The CSE also seeks approval for three rule changes related to the handling of customer orders on the Exchange. Generally, these requirements are designed to increase order exposure and ensure the timely execution and display of limit orders held by CSE dealers.

First, the Exchange proposes to adopt Interpretation and Policy .01 to CSE Rule 11.9(u) regarding price improvement of certain market orders. This policy would require that, in greater than minimum variation markets, a preferencing dealer

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.* To this end, the Commission described the CSE as ''unique among U.S. stock exchanges in that it is totally automated and utilizes a competing market maker system.''

[13] *See* Securities Exchange Act Release No. 34493, *supra* note 6. Specifically, the Commission requested that the CSE demonstrate that preferencing added depth and liquidity to the CSE market, and improved quotations. The Commission stated that if the CSE could not make such a showing, the Commission would not be inclined to extend the preferencing program. Accordingly, the CSE submitted several reports and letters containing data that it believes makes the required showing. *See infra* note 36.

[14] *See* Securities Exchange Act Release No. 34078 (May 18, 1994), 59 FR 27082 (May 25, 1994). Unlike the CSE program, the BSE competing specialist program does not alter time priority among competing specialists quoting at the intermarket best bid or offer.

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

[16] The Commission also is currently considering comment received regarding a series of order handling rules it proposed last September. *See* Securities Exchange Act Release No. 36310 (September 29, 1995), 60 FR 52792 (October 10, 1995).

[17] *See* CSE Rule 11.9(u).

[18] The majority of agency crosses are the result of a limit order resident in the dealer's proprietary system at the ITS/BBO, which is matched with an incoming contra-side market order. For example, if the ITS/BBO is 20 bid—20⅛ asked, and a dealer has a limit order to buy at 20, an incoming market sell order will be matched with that limit order because the dealer may not trade for its own account ahead of its own customer limit order. *See* CSE Rule 12.6(b).

[19] If there is a public agency order on the CSE's book, the system rejects the dealer's principal side of the attempted cross or, in the case of an attempted public agency cross, rejects the agency order that is on the same side of the market as the pre-existing order on the book.

[20] Specifically, the index arbitrage restriction permits preferencing dealers to preference their customer order flow that is related to index arbitrage only on plus or zero plus ticks when the Dow Jones Industrial Average (''DJIA'') declines by fifty points or more from the previous day's closing value. *See* Securities Exchange Act Release No. 28866, *supra* note 5.

immediately execute market orders routed to him or her for execution on the CSE at an improved price or expose the orders on the Exchange for a minimum of thirty seconds to give other market participants an opportunity to provide an improved price.[21] A preferencing dealer may expose a market order by representing the orders at an improved price in his or her CSE quote, or by placing the order on the CSE's central limit order book at an improved price.[22] This requirement, however, will not be imposed upon members during unusual market conditions or if such action would not be in the best interest of the customer.[23]

Second, the Exchange proposes to adopt Interpretation and Policy .02 to CSE Rule 11.9(u) regarding public agency limit order protection. Under this policy, a public agency limit order routed to a CSE dealer for execution on the CSE would be filled if (i) the bid or offer at the limit price has been exhausted in the primary market; (ii) there has been a price penetration of the limit order in the primary market; or (iii) the issue is trading at the limit price on the primary market unless it can be demonstrated that such order would not have been executed if it had been transmitted to the primary market or the customer and the Designated Dealer agree to a specific volume related or other criteria for requiring execution of limit orders.[24] This policy is designed to ensure that limit orders routed to CSE dealers for execution on the CSE receive timely executions relative to same-priced limits orders on the primary markets, and is therefore referred to as ''primary market print protection.''[25]

Finally, the Exchange proposes to amend Interpretation and Policy .01 to CSE Rule 12.10 regarding the handling of public agency limit orders priced either at or between the ITS/BBO. The policy currently requires that a CSE dealer display all or a representative portion of such orders in the national market system unless the order is executed immediately or the customer requests that it not be displayed.[26] Under the amended rule, a CSE dealer must display on the CSE all or a representative portion of public limit orders that he or she represents as agent for execution on the CSE, unless the order is executed immediately or the customer requests that it not be displayed.[27] A dealer may satisfy this requirement by representing limit orders in his or her CSE quote, or by placing the agency orders (or a representative portion) on the CSE's central limit order book.[28] In addition, if a representative portion of an order is executed, the CSE dealer must display all or a representative portion of the remainder of the order until the order is filled in its entirety.

IV. Summary of Comments

The Commission received 18 comment letters from a total of 13 commenters. Eleven of the commenters opposed the DPP and requested that the Commission disapprove the CSE's request for permanent approval of the program. The Commission received comment letters from the New York Stock Exchange (''NYSE''),[29] Boston Stock Exchange (''BSE''),[30] American Stock Exchange (''Amex''),[31] and The Specialist Association,[32] as well as from other interested parties.[33] The commenters that opposed the continuation of preferencing generally raised similar concerns regarding the practice of preferencing. As discussed below, these commenters asserted that preferencing, and the resulting internalization of order flow (1) decreases order interaction on the CSE, which negatively affects order execution quality, and (2) detrimentally affects the quality of the CSE market and the broader market.[34] In addition, the NYSE

[21] When exposing a market order on the Exchange for price improvement, a dealer stops the order to guarantee that the customer receives the then current best market price in the event that the order does not receive price improvement. The Commission has proposed a rule requiring that all market orders receive an opportunity for price improvement. *See* Securities Exchange Act Release No. 36310, *supra* note 16. The CSE order exposure policy would be superseded by any final rule adopted by the Commission to the extent that the Commission's rule imposed greater obligations on market participants.

[22] A dealer that represents an order in its CSE quote does not enter a public agency order into NSTS. Thus, representing an order in the dealer's quote would not result in the order being automatically matched with other orders in NSTS, such as with paired order trades entered by CSE preferencing dealers. However, if the customer limit order is at a price that is better than the ITS/BBO, inclusion in the CSE dealer's quote will narrow the market in that security.

[23] This provision is intended to apply to unusual market conditions (*e.g.*, fast moving markets) and situations where it would be inconsistent with a preferencing dealer's best execution duty to expose the order. Conversation between David Colker, Executive Vice President and Chief Operating Officer, CSE, and N. Amy Bilbija, SEC, on August 14, 1995.

[24] In unusual trading situations, a Designed Dealer may seek relief from these requirements from two Trading Practices Committee members or a designated member of the Exchange staff who would have the authority to set execution parameters.

[25] The Commission notes that the Chicago Stock Exchange and Boston Stock Exchange currently have nearly identical primary market print protection policies. *See* CHX Rules, Article XX, Rule 37(a); and BSE Rules, Chapter II, Section 33, Interpretations and Policies .01.

[26] The Commission also has proposed a similar limit order display rule for all markets. Accordingly, the CSE limit order display policy would be superseded by any final rule adopted by the Commission to the extent that the Commission's rule imposed greater obligations on market participants. *See* Securities Exchange Act Release No. 36310, *supra* note 16.

[27] If the limit order is for 500 shares or fewer, a dealer must display the entire order. If the limit order is for more than 500 shares, a dealer must display at least 500 shares, but is not required to display the entire order. Conversation between David Colker, Executive Vice President and Chief Operating Officer, CSE, and N. Amy Bilbija, SEC, on August 14, 1995. The Commission notes that the rule applies to all CSE dealers, not only preferencing dealers.

[28] *See supra* note 22.

[29] *See* letters from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan Katz, Secretary, SEC, dated March 16, 1995 (''NYSE Letter No. 1''); Daniel Park Odell, Assistant Secretary, NYSE, to Jonathan Katz, Secretary, SEC, dated April 5, 1995 (''NYSE Letter No. 2''); and James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, SEC, dated September 5, 1995 (''NYSE Letter No. 3''). In addition, the NYSE submitted several comment letters regarding prior extensions of the CSE's preferencing program.

[30] *See* letter from John Fitzgerald, Executive Vice President, BSE, to Howard Kramer, Associate Director, Division of Market Regulation, SEC, dated March 24, 1995 (''BSE Letter'').

[31] *See* letter from James Duffy, Executive Vice President and General Counsel, Amex, to Jonathan Katz, Secretary, SEC, dated April 20, 1995 (''Amex Letter'')

[32] *See* letters from David Humphreville, Executive Director, The Specialist Association, to Jonathan Katz, Secretary, SEC, dated April 3, 1995 (''Specialist Association Letter No. 1''); and July 27, 1995 (''Specialist Association Letter No. 2'').

[33] *See* letter from The Honorable Thomas J. Bliley, Jr., Chairman, Committee on Commerce, U.S. House of Representatives, and The Honorable Jack Fields, Chairman, Subcommittee on Telecommunications and Finance, U.S. House of Representatives, to Arthur Levitt, Jr., Chairman, SEC, dated July 6, 1995 (supporting a disclosure approach to regulation of broker order routing practices); letter from The Honorable Alfonse M. D'Amato, Chairman, Committee on Banking Housing and Urban Affairs, United States Senate, to Arthur Levitt, Jr., Chairman, SEC, dated July 17, 1995 (opposing preferencing); letter from The Honorable John D. Dingell, Ranking Member, Committee on Commerce, U.S. House of Representatives, to Arthur Levitt, Jr., Chairman, SEC, dated June 28, 1995 (''Dingell Letter'') (opposing preferencing); letter from The Honorable Dan Frisa, U.S. House of Representatives, to Arthur Levitt, Jr., Chairman, SEC, dated August 9, 1995 (opposing preferncing); letters from Paula Gavin, Chair, NYSE Individual Investors Advisory Council, to Arthur Levitt, Jr., Chairman, SEC, dated July 17, 1995, and October 2, 1995 (opposing preferencing); letter from Thomas E. O'Hara, Chairman, Board of Trustees, National Association of Investors Corporation, to Arthur Levitt, Jr., Chairman, SEC, dated September 20, 1995 (opposing preferencing); letter from Wayne F. Haefer, to Arthur Levitt, Jr., Chairman, SEC, dated September 20, 1995 (opposing preferencing); and letter from Bruce B. Johnson, for Otten, Johnson, Robinson, Neff & Ragonetti, P.C., to Arthur Levitt, Jr., Chairman, SEC, dated October 5, 1995 (opposing preferencing).

[34] The NYSE attempted to evaluate preferencing by constructing a program, using data from the Consolidated Tape (''CT''), Consolidated Quotation System (''CQS''), and ITS, to identify paired order trades (''POTs'') occurring on the CSE. A POT was defined as a trade printed on the CSE that was not the result of interaction with the existing CSE quote, *e.g.*, not a trade between two distinct CSE

commented on the CSE's proposed order handling policies.[35] The CSE submitted several letters in response to the comments and provided data requested by the Commission.[36]

A. Order Execution Quality

Several commenters asserted that the alteration of priority rules to facilitate internalization discourages interaction between dealers and among customer orders in the CSE market.[37] Specifically, commenters stated that preferencing discourages interdealer competition on the CSE and, as a result, the CSE functions as a mere facility by which its members can receive a print for an exchange execution for internalized trades.[38] The NYSE asserted that, as a result of preferencing, there are multiple proprietary trading systems within the CSE market wherein CSE members can internalize order flow with minimal probability of that order flow interacting with the orders of other CSE members.[39] In response, the CSE indicated that an average of 8,000 trades per month result from interaction between CSE dealers.[40] In addition, the CSE believes interdealer activity has been increasing due to efforts by the Exchange to encourage quote competition among its dealers.[41]

Commenters asserted that because preferencing provides a disincentive for interdealer competition, customer orders are denied the opportunity to interact with other trading interest in the market.[42] Several commenters further stated that preferencing undermines the proper price discovery and market transparency functions of the agency auction market and makes best execution of customer orders less likely.[43] In this regard, commenters asserted that preferencing makes it more profitable for dealers to internalize orders by maintaining limit orders on their internal proprietary systems until they become marketable, rather than placing them on the Exchange's central limit order book where they would be displayed and have an opportunity to interact with other customer orders.[44] In addition, commenters charged that because orders on the CSE's central limit order book must be satisfied before a dealer can internalize orders at the same price, it is to the advantage of dealers that seek to internalize customer order flow to discourage the placing of limit orders on the CSE's book.[45] As a result, the commenters maintained that there are relatively few, if any, limit orders sent to the CSE's book.[46]

The CSE stated that is has encouraged dealers to place limit orders on the NSTS book, but that no exchange has the authority to dictate firm order handling practices by requiring that firms place their limit orders in the exchange's book.[47] The NYSE believes, however, that while the CSE lacks the authority to dictate that its preferencing dealers enter limit orders on the CSE, the CSE could require firms to route a mix of order types to CSE preferencing dealers.[48]

With respect to market order exposure, the CSE maintained that the rate of price improvement on the Exchange compares favorably to other exchanges. The CSE asserted that 59% of CSE executions in greater than minimum variation markets were printed between the ITS/BBO in the fourth quarter of 1995, and that an additional 4% of the orders received price improvement after being exposed at prices that narrowed the ITS/BBO.[49] The NYSE asserted that the CSE does not compare favorably to the other exchanges and reported that only approximately 45% of the executions on CSE occur between the ITS/BBO.[50] Finally, the NYSE noted that the CSE is the only exchange that does not have rules requiring members, when trading as principal with an agency order, to publicly cross the order in the market and quote the agency order 1/8 better so as to permit other members to improve the price.[51]

B. Market Quality

Several commenters asserted that the Commission should not permanently approve the DPP because the CSE has not demonstrated that preferencing results in added depth and liquidity to its market, nor improved quotations.[52]

members. The NYSE included analysis for five consecutive trading days in March 1995. *See* NYSE Letter No. 2, *supra* note 29.

[35] *See* NYSE Letter No. 3, *supra* note 29.

[36] *See* letters from David Colker, Executive Vice President and Chief Operating Officer, CSE, to Arthur Levitt, Jr., Chairman, SEC, dated January 18, 1995 (''CSE Letter No. 1''); Jonathan Katz, Secretary, SEC, dated April 26, 1995 (''CSE Letter No. 2''), and June 14, 1995 (''CSE Letter No. 3''); Brandon Becker, Director, Division of Market Regulation, SEC, dated June 19, 1995 (''CSE Letter No. 4''); Richard Lindsey, Director, Division of Market Regulation, SEC, dated January 31, 1996 (''CSE Letter No. 5'').

[37] *See* NYSE Letter No. 2, *supra* note 29; BSE Letter, *supra* note 30; Amex Letter, *supra* note 31; and Specialist Association Letters Nos. 1 and 2, *supra* note 32.

[38] *See* NYSE Letters Nos. 2 and 3, *supra* note 29; and Specialist Association Letter No. 2, *supra* note 31. The NYSE claimed that a total of 87.7% of CSE executions were POTs. Further, the NYSE asserted that in a subset of securities in which there were only preferencing dealers, 94.2% of all trades were POTs. The NYSE asserted that only 4.8% of CSE trades could be characterized as trades between CSE dealers.

[39] *See* NYSE Letter No. 2, *supra* note 29.

[40] *See* CSE Letter No. 1, *supra* note 36.

[41] *Id.* In January 1994, the Exchange proposed quoting parameters that would require dealers to maintain quotation spreads that are no wider than 125% of the three narrowest ITS quotations. As a result, in some circumstances, dealers would be required to maintain quotes that match at least one side of the ITS/BBO. In addition, the Exchange proposed to prohibit the use of computer-generated quotations that track the primary market quotation. Although the rule proposal has not yet been approved by the Commission, the CSE maintains that many of its dealers began to comply with these quoting policies voluntarily in January 1994. *See* File No. SR–CSE–95–01.

[42] *See* NYSE Letter No. 2, *supra* note 29; BSE Letter, *supra* note 30; Amex Letter, *supra* note 31; and Specialist Association Letters Nos. 1 and 2, *supra* note 32. *See also* comment letters cited *supra* note 33 that opposed preferencing

[43] *See* Amex Letter, *supra* note 31; and Specialist Association Letters No. 1, *supra* note 32. *See also* comment letters cited *supra* note 33 that oppose preferencing.

[44] *See* NYSE Letter No. 2, *supra* note 29; BSE Letter, *supra* note 30; Amex Letter, *supra* note 31; and Specialist Association Letters Nos. 1 and 2, *supra* note 32.

[45] *See* NYSE Letter No. 2, *supra* note 29; BSE Letter, *supra* note 30; Amex Letter, *supra* note 31.

[46] *Id.*

[47] The CSE reported that in the first quarter of 1995, 2104 preferenced orders interacted with pre-existing public agency limit orders on the CSE's book. *See* CSE Letter No. 4, *supra* note 36. The CSE reported that in the fourth quarter of 1995, 4802 preferenced orders interacted with agency limit orders on the CSE's book. *See* CSE Letter No. 5, *supra* note 36. As described above, the CSE is proposing to require dealers to display their limit orders by either placing the orders on the Exchange's central limit order book, or representing the orders in their CSE quote.

[48] The NYSE states as an example that the CSE could require dealers to route the same ratio of market orders and limit orders to the CSE. *See* NYSE Letter No. 2, *supra* note 29.

[49] *See* CSE Letter No. 5, *supra* note 36. In addition, the CSE reported that for the first quarter of 1995, 57% of CSE executions in greater than minimum variation markets were executed between the ITS/BBO, and that an additional 3% of the orders received price improvement after being exposed at prices that narrowed the ITS/BBO. *See* CSE Letter No. 4, *supra* note 36.

[50] *See* NYSE Letter No. 2, *supra* note 29. Based on its own analysis, the NYSE asserted that during the month of December 1994, CSE's rate of price improvement was 48.7% in 1/4 point markets, 48% in 3/8 point markets, and 37.7% in 1/2 point markets. The NYSE also stated that, contrary to the CSE's contention, price improvement is possible in minimum variation markets and that 17.6% of NYSE SuperDot market orders receive price improvement in 1/8 point markets. *Id.* The BSE also measures price improvement in minimum variation markets, and maintains that it provides price improvement approximately 4% of the time when the ITS/BBO spread is 1/8 point. *See* BSE Letter, *supra* note 30.

[51] *See* NYSE Letter No. 2, *supra* note 29. As described above, the CSE is proposing to require dealers to either execute market orders in greater than minimum variation markets between the spread, or expose the orders for 30 seconds to give other market participants an opportunity to provide price improvement.

[52] *See* NYSE Letters Nos. 2 and 3, *supra* note 29; BSE Letter, *supra* note 30; Amex Letter, *supra* note 31; Specialist Association Letters Nos. 1 and 2, *supra* note 32; and Dingell Letter, *supra* note 33. The commenters note that the Commission

Continued

The NYSE and BSE asserted that the existence of preferencing dealers in an issue actually diminishes the quality of the CSE quotes.[53] In evaluating whether preferencing dealers add to the quality of the CSE market, the NYSE believes that preferenced trade activity should not be considered.[54] Rather, the NYSE believes that the measure of a preferencing dealer's contribution to the market is whether it maintains quotations and handles order flow that interacts with other CSE members and market participants.[55] As discussed above, the NYSE estimated that approximately 88% of CSE trades are executed without interaction between CSE members.[56] In addition, the NYSE believes that ITS inbound activity is an indication of competitive quoting, in that quotes at the ITS/BBO draw orders to trade on the CSE from other markets. In this regard, the NYSE asserted that the percentage of CSE trades in a stock involving orders from other market participants (*i.e.*, ITS inbound activity) decreased as the number of preferencing dealers in an issue increased.[57] Similarly, the BSE argued that the percentage of ITS inbound activity attributable to preferencing dealers should be higher in proportion to the number of trades and shares they execute on the CSE.[58]

The CSE maintained that preferencing dealers add depth and liquidity to the market through quotes at the ITS/BBO. In its initial report, the CSE analyzed its average quote spread, average quote size, the relation of CSE quotes to the ITS/BBO, total trade activity, ITS inbound trade activity, and customer order price improvement.[59] In every category the CSE reported that its performance either equaled or exceeded the other regional exchanges.[60] Several commenters noted that the CSE's data included all dealers on the CSE and asserted that inclusion of non-preferencing dealers improved the overall results.[61] In response, the CSE submitted an analysis that isolated the trading activity of preferencing dealers in the above categories, and reported that their performance also equaled or exceeded the other regional exchanges.[62] Most recently, the CSE reported that 71% of the CSE's quotations match at least one side of the ITS/BBO,[63] and that the CSE was responsible for generating 6% of all quotes that established a new ITS/BBO.[64]

Several commenters asserted, however, that any liquidity that may be provided by the CSE is artificial due to the inaccessibility of the CSE's quotes.[65] Commenters charged that CSE quotes change too quickly for other market participants to have a meaningful opportunity to send ITS orders to the CSE.[66] Commenters believe that the rapid quote changes are caused by a combination of multiple dealers in the single market and the use by some CSE dealers of automated systems that generate quotations.[67] The CSE maintained, however, that its cancellation rate is not increased by computer-generated quotations, and that 87% of quote changes that result in cancellations are displayed to other market participants for over one minute.[68]

Finally, the Commission received two preliminary drafts of an academic paper from Indiana University that studies the short term effects of preferencing on market quality (''IU Study'').[69] The IU Study looked for potential shifts in market share, bid/ask spreads, and liquidity premiums [70] for 256 securities that the authors believed were preferenced during the entire pilot (1991–1995). The IU Study's preliminary results indicated that, while internalization results in significant volume redistribution, the preferencing program does not appear to have had an adverse effect on the measures of market quality.[71] The IU study noted, however,

requested that the CSE demonstrate that preferencing added depth and liquidity to its market, improved quotations, and generally had a beneficial competitive effect on the national market system. *See* Securities Exchange Act Release No. 34493, *supra* note 6.

[53] *See* NYSE Letter No. 2, *supra* note 29; and BSE Letter, *supra* note 30.

[54] The CSE maintains, however, that the preferencing program has provided additional depth and liquidity for a substantial amount of public order flow, and that it is therefore appropriate for the Commission to include preferenced trade activity in its analysis. *See* CSE Letter No. 3, *supra* note 36.

[55] *See* NYSE Letter No. 2, *supra* note 29. *See also* BSE Letter, *supra* note 30 (asserting that CSE dealers do not trade at their displayed quotes); and *infra* note 60.

[56] *See* NYSE Letter No. 2, *supra* note 29. The NYSE maintained that for stocks in which there were only preferencing dealers, 94% of the trades were POTs. The NYSE asserted that this data evidenced that the CSE is being used by its members as a printing mechanism for their own pre-arranged trades.

[57] The NYSE reported that, as a percentage of total trades, ITS inbound trades were 5.8% for stocks with one preferencing dealer, 3.8% for stocks with two preferencing dealers, and 2.5% for stocks with three preferencing dealers. In contrast, the NYSE reported that in stocks with both preferencing and non-preferencing dealers ITS inbound trades were 7.7% of total trades. The NYSE also asserted that a single non-preferencing CSE dealer had more ITS inbound activity than the combined total of the 9 preferencing dealers during the week studied. *See* NYSE Letter No. 2, *supra* note 29.

[58] *See* BSE Letter, *supra* note 30.

[59] *See* CSE Letter No. 1, *supra* note 36.

[60] *See id.* The BSE noted that the CSE's data showed that the BSE's average size for quotes at the ITS/BBO (1,325 shares) far exceeded that of the CSE (700 shares). While the CSE data also indicated that the BSE only quotes at the ITS/BBO 5% of the time compared to approximately 71% for the CSE, the BSE asserts that CSE dealers do not trade at their quotes and that the size of CSE quotes is therefore meaningless. *See* BSE Letter, *supra* note 30.

[61] *See* NYSE Letter No. 2, *supra* note 29; and BSE Letter, *supra* note 30.

[62] *See* CSE Letter No. 3, *supra* note 36. The CSE reported that for a subset of 237 stocks in which there were only preferencing dealers (1) the average quotation spread was ¼ point, which the CSE reported was narrower than any other regional exchange, (2) 60% of their quotes matched one or both sides of the ITS/BBO, while none of the other exchanges exceeded 30%; and (3) the CSE generated 4% of all quotes that established a new ITS/BBO, which exceeded the performance of all other regional exchanges. The CSE also asserted that it had the highest average quote size (700 shares) of any regional stock exchange in the 237 stocks. The CSE asserted that the depth provided by preferencing specialists when their quotes establish or match the ITS/BBO actually contributed more depth to the national market than all the other regional exchanges when viewed in conjunction with the lower rates at which the regional exchanges quote at the ITS/BBO. The CSE also maintained that preferencing dealers executed almost half of all ITS inbound activity in those issues that have at least one preferencing dealer, and that preferencing dealers' ITS/total trade ratio of 3.5% compared favorably to the NYSE's ITS/total trade ratio of 2.8%.

[63] *See* CSE Letter No. 5, *supra* note 36 (data from fourth quarter 1995). The CSE reported that in the first quarter of 1995 73% of the CSE quotes matched at least one side of the ITS/BBO. *See* CSE Letter No. 4, *supra* note 36.

[64] *See* CSE Letters No. 4 and 5, *supra* note 36.

[65] *See* NYSE Letter No. 1, *supra* note 29; BSE Letter, *supra* note 30; Amex Letter, *supra* note 31; and Specialist Association Letter No. 1, *supra* note 32.

[66] *See* NYSE Letter Nos. 1 and 2, *supra* note 29; BSE Letter, *supra* note 26 (incorporating by reference letter from John I. Fitzgerald, Executive Vice President, BSE, to Jonathan G. Katz, Secretary, SEC, dated April 29, 1994); and Amex Letter, *supra* note 31.

[67] *Id.*

[68] The CSE analyzed 2,626 CSE ITS cancellations that occurred on eight randomly chosen trading days between August 4, 1994, and January 13, 1995. The CSE concluded that, of the total cancellations analyzed, 4% were caused by erroneous pricing, 9% were the result of ''fishing,'' and 22% were the result of stock having traded prior to receipt of the ITS commitment. The remaining cancellations were due to the CSE's quote changing before the commitment to trade was received by the CSE system. In this regard, the CSE asserts that 87% of the quotes that changed prior to receipt of ITS commitments to trade had been displayed for more than one minute, and more than 50% of these quotes had been displayed for over five minutes. *See* CSE Letter No. 2, *supra* note 36.

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

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

[71] Although the IU Study found that spreads and liquidity premiums decreased, because of the long time intervals involved, the study noted that it could not rule out a general decreasing trend in these measures.

that to the extent that retail brokers internalizing trades reduce (or even eliminate) commissions, investor welfare is improved.

In this regard, the CSE asserted that its efficient electronic environment, coupled with the ability of member firms to become specialists in a larger number of desirable stocks than is feasible on other exchanges, results in cost efficiencies that flow through to customers.[72] Some commenters, however, maintained that there is no evidence to indicate that the purported efficiencies from internalization are passed along to the CSE dealers' customers.[73]

C. Order Handling Policies for Preferencing Dealers

As described above, the CSE also proposed policies regarding order exposure and limit order protection for preferencing dealers. The NYSE criticized the order exposure portion of the proposed order handling policies, and stated that these policies will not provide meaningful benefits to investors or to the market in general. Specifically, the NYSE maintained that the proposed order exposure requirement will affect as few as 8% of preferenced orders.[74] The NYSE further asserted that, while some customer orders may receive price improvement as a result of the policy, preferencing dealers will continue to have an opportunity to trade against the order at the improved price, negating the opportunity for two customer orders to meet without dealer intervention. The NYSE also asserted that even if CSE dealers expose orders for 30 seconds, the short duration of the exposure is unlikely to provide other market participants sufficient time to trade with those orders.[75]

V. Commission Data

As discussed above, the Commission received substantial data from commenters and the CSE. The various studies result in differing conclusions regarding the quality of executions achieved on the CSE by preferencing dealers, as well as the quality of the CSE market. In response to the differing assertions made by the commenters and the CSE, the Commission's Office of Economic Analysis (''OEA'') evaluated CSE quotations and transactions. In considering the CSE trade and quotation data, the OEA distinguished between the trading activity of preferencing versus non-preferencing dealers.

During the period considered, preferencing dealers accounted for more than 90% of trades and two-thirds of share volume on the CSE. The 281 stocks where preferencing dealers accounted for 80% to 99% of total CSE trades were the most actively traded stocks on the CSE.

The data analyzed by the OEA also showed that CSE preferencing dealers often matched the NYSE BBO, and that the percentage of time that the CSE quotes matched those on the NYSE was greatest for those stocks in which preferencing takes place. Specifically, for the 281 stocks in which preferencing dealers accounted for 80% to 99% of total CSE trades, the CSE quote on average matched the NYSE best bid approximately 54% of the time and the NYSE best offer nearly 61% of the time. When matching at least one side of the ITS/BBO, the CSE's quotation depth in these 281 stocks averaged over 720 shares. For all quotes in the 281 stocks, the CSE quotation depth averaged close to 900 shares.

VI. Discussion

The Commission has considered carefully the issues presented by the CSE's preferencing program, including its potential effects on the execution of customer orders, competition between markets, and CSE market quality. In particular, the Commission considered carefully the commenters' concerns regarding the alteration of time priority, the lack of order interaction on the CSE, and the impact on public customers and the quality of the CSE market. Similarly, the Commission has reviewed the CSE's findings that the DPP has increased the CSE's market share without affecting the quality of its markets or execution of customer orders.

The DPP has proven to be a competitive benefit to the CSE. In addition, after analyzing substantial data provided by the CSE and commenters, as well as conducting its own data collection and examination, the Commission believes that the DPP also has improved CSE quotations, and has added to the depth and liquidity of the CSE market. In addition, the Commission believes that the DPP, as supplemented by the adoption of policies related to the handling of customer orders, is not necessarily inconsistent with best execution of customer orders. For these reasons, discussed more fully below, the Commission believes 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. In particular, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,[76] which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade and to perfect the mechanism of a free and open market and a national market system and to protect investors and the public interest. The DPP, as amended, also is consistent with Section 11A of the Act,[77] which generally promotes, among other things, the development of a national market system for securities to assure economically efficient execution of securities transactions and fair competition among brokers and dealers, among exchange markets and markets other than exchange markets.

The Commission supports efforts by exchanges to provide increased liquidity and competition on their trading floors or trading systems. Such efforts can enhance market quality and enable exchanges to compete more effectively for order flow. The CSE's preferencing program was designed to attract more market making and order flow to the Exchange, and it is apparent from the data that the DPP has led to a substantial increase in the CSE's trading volume.[78] At the same time, the Commission has been very concerned about the market structure issues presented by internalization of order flow and its potential effect on the handling of customer orders and the ability of broker-dealers to fulfil their duty to seek best execution of customer orders. Accordingly, in scrutinizing the CSE's preferencing pilot, including the numerous comment letters, the Commission has considered, among other things, preferencing's effect on achievement of economically efficient execution of securities transactions, fair competition among brokers and dealers

[72] *See* CSE Letter No. 1, *supra* note 36.

[73] *See* NYSE Letter No. 2, *supra* note 29; and BSE Letter, *supra* note 30. The Specialist Association cites to a draft article by professors Huang and Stoll of the Owen Graduate School of Management that concludes that internalization and preferencing in the over-the-counter market limit the incentive of market participants to narrow spreads, with the result that Nasdaq execution costs are twice NYSE costs. The Specialist Association concludes that the same result occurs on the CSE. *See* Specialist Association Letter 2, *supra* note 32 (*citing* Huang and Stoll, *Dealer Auction Markets: A Pencil Comparison of Execution Costs on NASDAQ and the NYSE* (June 6, 1995) (draft article)).

[74] The NYSE states that only approximately 15% of preferenced trades occur in markets with a quotation spread that is greater than the minimum variation, and that according to the CSE, dealers already trade between the ITS/BBO 55% of the time. Thus, NYSE concludes that the order exposure rule would apply to only 8% of the order handled by preferencing dealers. *See* NYSE Letter No. 3, *Supra* note 29.

[75] The NYSE believes that the 30 seconds mandated for order exposure could lead to an increase in the CSE's ITS cancellation rate. *Id.*

[76] 15 U.S.C. § 78f(b).

[77] 15 U.S.C. § 78k–1.

[78] *See* CSE Letters, *supra* note 36.

and among exchange markets, as well as the practicability of brokers executing investors' orders in the best market.

Although preferencing enables CSE dealers to internalize order flow, the CSE's unique system is not necessarily inconsistent with a broker-dealer's duty to seek best execution of customer orders.[79] Dealers preference their customer order flow on the CSE by matching themselves with a customer order and sending a paired trade priced at or between the ITS/BBO to NSTS for execution. Upon receiving the paired order, NSTS replaces the preferencing dealer's side of the trade if there are any public agency orders at the same price on the CSE's central limit order book. If there are no such public agency orders, the paired trade is executed, regardless of dealer quotes resident in the system. In this manner, the preferencing program protects customer limit orders entered into NSTS while permitting broker-dealers to retain their own customer order flow where those orders would have otherwise been executed by another broker-dealer. Accordingly, preferencing alters the pre-existing CSE time priority rule that determines which broker-dealer is entitled to execute a customer order in favor of the broker-dealer that brought the order flow to the CSE.

Several commenters express concern, however, that the ability of dealers to maintain and execute their order flow without interruption from other professionals trading on the CSE provides an incentive for dealers to delay sending limit orders to the Exchange until they are marketable,[80] and that all orders on the CSE are thereby deprived of the benefits accruing from order interaction. In this regard, the Exchange is adopting policies for the display and timely execution of limit orders held by preferencing dealers. Under the policies, a preferencing dealer will be required to display limit orders he or she represents as agent priced at or better than the ITS/BBO on the CSE[81] and to execute such limit orders in a timely manner relative to executions on the primary market.[82]

The Commission believes that these limit order policies should promote order interaction on the CSE through improved quotations and increased volume on the Exchange's central limit order book, as well as add to the quality of information displayed to the national market system. The Commission notes, however, that the limit order display policy permits a CSE dealer to display orders in his or her quotes, rather than placing a customer limit order in NSTS where it would have the opportunity to interact with customer orders from other CSE dealers. The holding of customer limit orders that are routed to a CSE dealer for execution on the Exchange outside of the NSTS system raises concerns regarding whether such order handling practices are consistent with a CSE dealer's best execution obligations. A CSE dealer that chooses to represent a customer limit order in his or her dealer quote instead of on the CSE's central limit order book must ensure that the customer is not disadvantaged as a result of that decision. Representing a limit order in his or her quote, rather than placing a limit order in the NSTS system where it can be matched with customer orders from other CSE dealers, places an obligation on the CSE dealer to monitor executions on the CSE to ensure that the limit order receives an appropriate execution.

While preferencing, and the resulting internalization of order flow by broker-dealers, may reduce order interaction on the CSE, preferencing does not inhibit dealers from executing customer orders between the ITS/BBO spread, nor from executing customer buy orders at the ITS best bid and sell orders at the ITS best offer. In this regard, the CSE reported that CSE executions in greater than minimum variation markets receive price improvement at a rate that is comparable to that of the NYSE.[83] Moreover, the CSE is adopting an order handling policy designed to give market orders an opportunity for price improvement through exposure on the CSE and to the national market system.[84] Under this policy, in greater than minimum variation markets, preferencing dealers will be required to immediately execute market orders at an improved price, or expose the orders to other market participants for an opportunity for price improvement.[85] Accordingly, these market orders cannot be internalized by a CSE dealer without first receiving an improved price or the opportunity for price improvement.

Although the data indicates that the quality CSE preferencing dealers' market making is presently comparable to other markets, the Commission recognizes that this quality relative to other markets may change over time. The Commission will periodically review the practices of broker-dealers that internalize order flow through the CSE's preferencing program. If a deterioration in the performance of preferencing dealers were evident, the Commission would consider whether the CSE would need to reinstitute time priority between dealer quotes on the CSE, or take other actions to improve the quality of market making on the CSE.

Furthermore, while the CSE's order handling policies and the data described in this order lead us to conclude that preferencing on the CSE is not necessarily inconsistent with a broker-dealer's duty to seek best execution, the Commission recognizes that CSE execution quality is, nevertheless, in large part dependent on the diligence of CSE members in handling customer orders. While this is true of all markets, it is of particular significance in markets where dealers execute customer orders as principal. It is therefore incumbent on the CSE, [86] as well as the Commission in its oversight capacity, to ensure that CSE members provide best execution of customer orders.

In this regard, the Commission's recent order routing disclosure requirements [87] and its proposed order handling rules [88] signal a renewed emphasis on the important of price improvement opportunities in connection with the duty to seek best execution. As the Commission has noted, while an automated order routing environment is not necessarily inconsistent with the achievement of best executive, broker-dealers choosing where to automatically route orders must assess periodically the quality of

[79] *See* Securities Exchange Act Release No. 28866, *supra* note 5. The CSE's NSTS system was designed to centralize the trading interest of geographically dispersed dealers by consolidating and disseminating the dealers' quotations, and providing a central limit order book for orders entered by the multiple dealers. Thus, the NSTS system provides a central location for CSE dealers to interact in a manner similar to a traditional exchange trading floor. Preferencing, however, suspends time priority between professional trading interest so that the multiple CSE dealers can execute their own customer orders without interruption by other dealers and is more akin to trading in the over-the-counter markets.

[80] *See supra* note 44.

[81] As described above, *see id.*, CSE dealers may display limit orders by either representing the orders in their CSE quotes or placing the orders on the CSE's central limit order book.

[82] Any preferencing dealer that failed to display limit orders or provide timely executions as required by these policies would violate CSE rules and would violate CSE rules and would be subject to disciplinary action by the Exchange.

[83] *See* CSE Letters Nos. 3, 4, and 5, *supra* note 36.

[84] Market orders exposed on the CSE will also be exposed to the national market system through the CSE's consolidated quote.

[85] Any preferencing dealer that failed to expose market orders as required by the policy would violate CSE rules and would be subject to disciplinary action by the Exchange.

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

[87] *See* Securities Exchange Act Release No. 34902, *supra* note 15.

[88] *See* Securities Exchange Act Release No. 36310, *supra* note 16.

competing markets to assure that order flow is directed to markets providing the most advantageous terms for their customers' orders.[89] Consequently, a broker-dealer may not simply employ default order routing to an affiliated CSE dealer without undertaking such an evaluation on an ongoing basis. A broker-dealer sending orders to the CSE must satisfy itself that its routing decision is consistent with its best execution obligations, irrespective of the firm's desire to internalize order flow through an affiliated CSE preferecing dealer. To reach this conclusion, the broker-dealer must rigorously and regularly examine the executions likely to be obtained for customer orders in the different markets trading the security, in addition to any other relevant considerations in routing customer orders.

The Commission also has considered carefully the commenters' concerns regarding the quality of the CSE's market, and whether preferencing has added depth and liquidity to the CSE market, and improved quotations.[90] In this respect, the Commission first considered data provided by the CSE and commenters. In light of the conflicting results from the two groups of data, the Commission collected additional data on its own. Overall the data indicates that preferencing dealers have added depth and liquidity to the CSE market. Specifically, data indicated that, for the 281 stocks in which preferencing dealers accounted for 80% to 99% of total CSE quote on average matched the NYSE best bid approximately 54% of the time and the NYSE best offer nearly 61% of the time, with an average depth of over 720 shares. This compares favorably to the data for other regional exchanges provided by the CSE.[91] Finally, for the 114 stocks traded on the CSE for which there are only preferencing dealers, the depth of CSE quotes matching at least one side of the NYSE BBO nearly 500 shares. This data indicates that preferencing dealers are providing competitive quotations that add liquidity to the national market.

Several commenters asserted that CSE quotations at the ITS/BBO do not add depth and liquidity to the national market because they change too quickly for other market participants to react. The data regarding CSE quotations was analyzed by the OEA on a time-weighted basis, so that, unlike the figures provided by the commenters and the CSE, the results took into consideration whether the quotes at the NYSE BBO were short in duration relative to quotes outside of the NYSE BBO. The resulting figures that CSE dealers match at least one side of the NYSE BBO between 54% and 61% of the time in the 281 securities, therefore, indicate that CSE quotes are often maintained at the NYSE BBO.

The Commission believes that the CSE's proposed limit order display policy could further add to the depth and liquidity of the CSE market. As discussed above, under the policy, CSE dealers will be required to display limit orders priced at or better than the ITS/BBO. Whether represented in the dealer's quote or placed on the Exchange's central limit order book, these orders will be included in the CSE consolidated quote and disseminated to the national market system. The Commission recently recognized that the display of limit orders could produce, among other benefits, spreads that more fully represent buying and selling interest in the market and enhance an investor's ability to monitor execution quality.[92] This, in turn, should increase competition among dealers based on their respective quotations.

Finally, the Commission believes it is consistent with the Act for the CSE to remove the restriction placed on the DPP during the pilot prohibiting preferencing dealers from making cash payments for order flow. The Commission believed that a limitation on the inducements for preferencing order flow was necessary until the Commission had an opportunity to assess the effects of the DPP pilot. As discussed above, the Commission has assessed the preferencing pilot and determined that it is not inconsistent with the Act, nor necessarily, a broker-dealer's obligation to seek best execution. Moreover, lifting the payment for order flow restriction on CSE preferencing dealers will place them in the same position as the CSE's other members. Accordingly, the Commission believes it is appropriate at this time to remove this restriction.

The Commission also is approving the DPP without the restriction on the number of stocks in which a single CSE dealer is permitted to register. These restrictions were necessary to limit the scope of the pilot program so that the CSE and Commission could evaluate the effects of preferencing. The Commission has completed such an evaluation and finds no reason to continue the restriction.

VII. Conclusion

The Commission believes it is consistent with the Act to approve the CSE's dealer preferencing program, as amended, on a permanent basis. In making this determination, the Commission has carefully evaluated the data provided by the CSE and commenters, as well as data collected by the Commission. The Commission has concluded that preferencing, as supplemented by the order handling policies, is not necessarily inconsistent with the attainment of best execution of customer orders, the maintenance of fair and orderly markets, or the protection of investors and the public interest under Section 6(b)(5) of the Act. In addition, the Commission believes approval of the DPP, as amended, also is consistent with Section 11A of the Act, particularly considering the order handling policies being adopted herein. Moreover, to the extent that preferencing does not have the effect of increasing order interaction, it fulfills the other national market system goals of Section 11A(a)(1)(C) of the Act, such as furthering competition among brokers and dealers, among exchange markets and markets other than exchange markets.

Nevertheless, Commission approval of the CSE's preferencing program is not a determination by the Commission that mere default routing by a firm to its affiliated preferencing dealer is consistent with a firm's best execution obligations. A broker-dealer associated with a preferencing dealer must still ensure that its order routing decisions and the preferencing dealer's order handling practices on the CSE (even if in technical compliance with the CSE's order handling requirements) are consistent with the firm's best execution obligations and assess periodically the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for its customers' orders.

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

[90] *See supra* note 52 and accompanying text.

[91] *See* CSE Letter No. 1, *supra* note 36.

[92] *See* Securities Exchange Act Release No. 36310, *supra* note 16.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[93] that the proposed rule change (SR–CSE–95–03), as amended, is approved.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–8397 Filed 4–4–96; 8:45 am]

BILLING CODE 8010–01–M

[Release No. 34–37042; File No. SR–DGOC–96–04]

Self-Regulatory Organizations; Delta Government Options Corp.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Addition of Prebon Securities (USA) Inc. as an Interdealer Broker for Delta Government Options Corp.'s Repurchase Agreement Clearance System

March 29, 1996.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on March 8, 1996, Delta Government Options Corp. (''DGOC'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by DGOC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The purpose of the proposed rule change is to accommodate Prebon Securities (USA) Inc. (''Prebon'') as an interdealer broker in DGOC's over-the-counter clearance and settlement system for repurchase agreement and reverse repurchase agreement transactions involving U.S. Treasury securities.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, DGOC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. DGOC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.[2]

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

Through its repo clearing system, DGOC clears repos and reverse repos that have been agreed to by DGOC participants through the facilities of interdealer brokers that have been specially authorized by DGOC (''authorized brokers'') to offer their services to DGOC participants.[3] Currently, Liberty Brokerage, Inc., RMJ Special Brokerage Inc., and Euro Brokers Maxcor Inc. are authorized brokers.[4] The purpose of the proposed rule change is to accommodate Prebon as an authorized broker in DGOC's clearance and settlement system for repo trades.

The proposed rule change will facilitate the prompt and accurate clearance and settlement of securities transactions, and therefore, the proposed rule change is consistent with the requirements of the Act, specifically section 17A of the Act, and the rules and regulations thereunder.[5]

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

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

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

Comments were neither solicited nor received.

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

The foregoing rule change has become effective pursuant to Section 19(b)(3)(A)(iii) of the Act[6] and Rule 19b–4(e)(4) thereunder,[7] in that the proposal effects a change in an existing service of a registered clearing agency that does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible and does not significantly affect the respective rights or obligations of the clearing agency or persons using the service. At any time within sixty days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communication 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, N.W., Washington, D.C. 20549. Copies of such filing also will be available for inspection and copying at DGOC. All submissions should refer to File No. SR–DGOC–96–04 and should be submitted by April 26, 1996.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[8]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–8396 Filed 4–4–96; 8:45 am]

BILLING CODE 8010–01–M

SMALL BUSINESS ADMINISTRATION

[License No. 03/03–0202]

Notice of Issuance of a Small Business Investment Company License

On January 26, 1996, a notice was published in the Federal Register (61 FR 2565) stating that an application had been filed by Mellon Ventures, L.P., One Mellon Bank Center, Room 151–3200, Pittsburgh, Pennsylvania 15258 with the Small Business Administration (SBA) pursuant to Section 107.102 of the Regulations governing small business

---

[93] 15 U.S.C. 78s(b)(2).

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

[2] The Commission has modified parts of these statements.

[3] For a complete description of the DGOC's repo clearance system, see Securities Exchange Act Release No. 36367 (October 13, 1995), 60 FR 54095.

[4] Securities Exchange Act Release Nos. 36367 (October 13, 1994), 60 FR 54095; and 36901 (February 28, 1996), 61 FR 8991.

[5] 15 U.S.C. 78q–1 (1988).

[6] 15 U.S.C. 78s(b)(3)(A)(iii) (1988).

[7] 17 CFR 240.19b 4(e)(4) (1995).

[8] 17 CFR 200.30–3(a)(12) (1995).