

Program to incorporate objective measures of specialist performance.<sup>4</sup> The current pilot program uses the BEACON system<sup>5</sup> to assess how well a specialist handles market and marketable limit orders routed to him for execution. For each specialist, a record of all action taken on relevant BEACON orders is accumulated in a special file, from which the four calculations described below are run.

First, Turnaround Time measures the average number of seconds from the receipt of a guaranteed market or marketable limit order (*i.e.*, for 1299 shares or less) in BEACON until it is executed (in whole or in part), stopped or cancelled.<sup>6</sup> Time continues to accumulate if the specialist just moves an order from the auto-ex screen to the manual one, until that order is executed (in whole or in part), stopped or cancelled.

Second, Holding Orders Without Action measures the number of market and marketable limit orders which are neither executed, stopped nor cancelled within twenty-five seconds. This measure differs from Turnaround Time in that orders of all sizes (including those already counted toward Turnaround Time) are analyzed.<sup>7</sup>

Third, Trading Between the Quote measures the number of market and marketable limit orders that are executed between the best consolidated bid and offer where the spread is greater than 1/8th.

Fourth, Executions in Size Greater than Best Bid and Offer ("BBO") measures the number of market and marketable limit orders which exceed, and are executed in a size larger than, BBO size.

For each of the above measures, including the revised questionnaire, the specialist receives a raw score. A ten point grading scale is then applied to ranges of raw scores. In computing the overall program score, the measures are assigned the following weights: Turnaround Time, 15%; Holding Orders Without Action, 15%; Trading Between

the Quote, 25%; Executions in Size Greater than BBO, 25%; Questionnaire, 20%.

At the same time as it incorporated the objective measures described above, the Exchange also revised the conditions for performance review. For each measure, the Evaluation Program states at what score specialist performance is deemed to be adequate.<sup>8</sup> A specialist who is deficient in the same one objective measure, for two out of three consecutive review periods, is required to appear before the Performance Improvement Action Committee.<sup>9</sup> The purpose of this meeting is to discuss, informally, possible methods of improving the specialist's performance.

If the specialist does not improve in the next review period, he is referred to the Market Performance Committee. The Market Performance Committee is directed to take such actions as it deems necessary and appropriate to address the deficient score. These actions include suspending a specialist's trading account, suspending his alternate specialist account privilege,<sup>10</sup> or reallocating his specialty stocks.<sup>11</sup>

Finally, the BSE also incorporated modified relative rankings into its Evaluation Program. Exchange staff reviews the performance of any specialists whose scores place them in the bottom ten percent of all BSE units.<sup>12</sup> In addition, a specialist who is

<sup>8</sup> A specialist is deficient in any individual objective measure or the overall program if he scores below certain minimum performance levels, as set forth below. Thus for his performance to be deemed adequate, a specialist must receive the following scores:

Overall Evaluation—at or above weighted score of 5.80

Turnaround Time—below 21.0 seconds (8 points)

Holding Orders Without Action—below 21% (7 points)

Trading Between the Quote—at or above 26% (5 points)

Executions Greater than BBO—at or above 76% (6 points)

Questionnaire—at or above weighted score of 50 (4 points)

<sup>9</sup> In the event a specialist receives a deficient score on the questionnaire alone, the Exchange staff reviews the deficient questionnaire to determine if there is sufficient reason to warrant informing the Performance Improvement Action Committee of potential performance problems.

<sup>10</sup> Alternate specialists provide added liquidity to the market, by promising to trade up to a certain amount of shares, on the request of the primary specialist. A specialist must apply for the privilege of being an alternate.

<sup>11</sup> The possible performance improvement actions are described in the BSE Rules under SPEP's Supplemental Material. This Supplemental Material is intended to provide specialists with adequate notice of the consequences of poor performance. It does not articulate any new substantive standards.

<sup>12</sup> In the event a specialist ranked in the bottom ten percent does not fall below the threshold for the overall program score, the Exchange staff reviews

deficient on the overall program score, for two out of three consecutive review periods, is required to appear before the Market Performance Committee, with the same possible consequences as above.<sup>13</sup>

The BSE has requested a twelve-month extension of the current pilot program to enable the Exchange to evaluate further the appropriateness of the measures and their respective weights, as well as the effectiveness of the overall evaluation program. The BSE believes that the proposed rule change will promote just and equitable principles of trade and aid in the perfection of a free and open market and a national market system. The Exchange states that the SPEP results weigh heavily in stock allocation decisions and, as a result, specialists are encouraged to improve their market quality and administrative duties.

### III. Discussion

The Commission believes that specialists play a crucial role in providing stability, liquidity and continuity to the trading of stocks. 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.<sup>14</sup> To ensure that specialists fulfill these obligations, it is important that the Exchange conduct effective oversight of their performance. The BSE's Specialist Performance Evaluation Program is critical to this oversight.

In its order approving the incorporation of objective measures of performance,<sup>15</sup> the Commission asked the Exchange to monitor the effectiveness of the amended Evaluation Program. Specifically, the Commission requested information about the number of specialists who fell below acceptable levels of performance for each objective measure, the questionnaire and the overall program; and about the specific measures in which each such specialist was deficient. The Commission also requested information about the number of specialists who, as a result of each

the performance of the specialist to determine if there is sufficient reason to warrant informing the Performance Improvement Action Committee of potential performance problems.

<sup>13</sup> See *supra*, text accompanying notes 10–11.

<sup>14</sup> Rule 11b–1, 17 CFR 240.11b–1 (1991); Ch. XV, ¶ 2155.01 of the BSE Rules.

<sup>15</sup> For a description of the Commission's rationale for approving the incorporation of objective measures of performance into the BSE's SPEP on a pilot basis, see February 1993 Approval Order, *supra*, note 3. The discussion in the aforementioned order is incorporated by reference into this order.

<sup>4</sup> See February 1993 Approval Order, *supra*, note 3. In addition to the substantive changes discussed below, SPEP was moved to Ch. XV, ¶ 2156 of the BSE Rules.

<sup>5</sup> BEACON is the BSE's automated order-routing and execution system. Of all incoming BEACON orders, SPEP collects data for regular buy and sell market and marketable limit orders only. Thus BEACON orders with qualifiers (*e.g.*, buy minus or sell plus, market-on-close, stop, stop limit, all or none, etc.) and crosses are excluded from analysis.

<sup>6</sup> Data collection starts when the stock opens on the primary market. Blocks of time are excluded in the event of trading halts, BEACON system failure, etc.

<sup>7</sup> The same exclusions apply for Holding Orders Without Action as for Turnaround Time. See *supra*, note 6.