

of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to eliminate the existing 100-share minimum automatic execution threshold and the rule governing the procedures by which specialists obtain permission to switch from automatic execution mode to manual execution mode. The proposed rule change was published for comment in the **Federal Register** on June 10, 2004.<sup>3</sup> The Commission received no comments on the proposal. This order approves the proposed rule change.

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange.<sup>4</sup> Specifically, the Commission finds that the proposal is consistent with the requirements of Section 6(b) of the Act,<sup>5</sup> in general, and Section 6(b)(5) of the Act,<sup>6</sup> in particular, which requires that the rule of the Exchange be designed to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Exchange has represented that under its current rules, a CHX specialist is required to permit its MAX system to automatically execute an unlimited number of orders for 100 shares or less at the then-prevailing national best bid or offer ("NBBO"), until the consolidated quotation stream reflects a change in the NBBO price. The CHX believes that this requirement imposes virtually unlimited liability on its specialists to fill orders at the NBBO regardless of the aggregate number shares actually available at the NBBO. The Exchange believes that this is an unintended and unwarranted consequence of automatic execution guarantees such as the Exchange's current rule and that by eliminating the 100-share minimum automatic execution threshold, specialists will have the option to act as agent for an order or manually execute the order, rather than have an order execute against him automatically at the NBBO. Thus, the Commission believes that eliminating the 100-share minimum

automatic execution threshold will give CHX specialists more flexibility in handling orders.

The Exchange has also represented that a number of CHX specialist firms have developed and are implementing a remote pricing functionality ("RFP") that permits specialists to respond to orders that are dropped for manual handling. The RFP functionality permits specialists to price individual orders. The RFP then provides the Exchange's MAX system with automated execution instructions for orders that otherwise would require further manual intervention of a CHX specialist. The Exchange believes that eliminating the 100-share minimum automatic execution threshold will grant specialists the option to handle more orders in this manner if they choose.

The Commission believes that the rule requiring specialists to guarantee automatic executions at the NBBO was one the CHX imposed on its specialists voluntarily in order to make its market more attractive to sources of order flow. The Commission believes that the business decision to potentially forego order flow by no longer requiring specialist to provide such automatic executions is a judgment the Act allows the CHX to make. The Commission notes, however, that specialists are required to handle all orders in accordance with their best execution obligations and the Commission Quote Rule<sup>7</sup> regardless of whether such orders are executed manually or automatically.

Finally, the Commission believes it is appropriate to delete the current CHX rule governing the procedures by which specialists are to obtain permission to switch from automatic execution mode to manual execution mode because the elimination of the 100-share minimum automatic execution threshold effectively permits CHX specialists to switch to manual execution mode at any time.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>8</sup> that the proposed rule change (File No. SR-CHX-2004-02) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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<sup>7</sup> 17 CFR 240.11Ac1-1.

<sup>8</sup> 15 U.S.C. 78s(b)(2).

<sup>9</sup> 17 CFR 200.30-3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50024; File No. SR-CHX-2004-10]

### Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Stock Exchange, Inc. Relating to Co-Specialist Assignments and Evaluations

July 15, 2004.

On February 3, 2004, the Chicago Stock Exchange, Inc. ("CHX") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to co-specialist assignments and evaluations. On May 12, 2004, CHX submitted Amendment No. 1 to the proposal.<sup>3</sup>

The proposed rule change, as amended, was published for notice and comment in the **Federal Register** on May 24, 2004.<sup>4</sup> The Commission received no comment letters on the proposal.

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<sup>5</sup> and, in particular, the requirements of Section 6(b)(5) of the Act.<sup>6</sup> Section 6(b)(5) requires, among other things, that the rules of the exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission notes that the proposed rule change, among other things, seeks to modify the co-specialist assignment and evaluation processes to shift the emphasis from evaluation questionnaire responses to execution quality data results (specifically, data on effective spread and speed of

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

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

<sup>3</sup> See letter from Ellen J. Nelly, Senior Vice President and General Counsel, CHX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation, Commission, dated May 11, 2004 ("Amendment No. 1"). Amendment No. 1 superseded and replaced the original rule filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 49721 (May 18, 2004), 69 FR 29592.

<sup>5</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>6</sup> 15 U.S.C. 78f(b)(5).

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

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

<sup>3</sup> See Securities Exchange Act Release No. 49793 (June 2, 2004), 69 FR 32645.

<sup>4</sup> In approving the proposal, the Commission has considered the rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

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

<sup>6</sup> 15 U.S.C. 78f(b)(5).

execution). Currently, execution quality data is not a factor for consideration during either the co-specialist assignment or evaluation processes. Instead such processes rely on the results of the co-specialist questionnaire, with substantial weight given to the questionnaire in the assignment process. Under the proposed rule change, the co-specialist questionnaire, while still a factor in the assignment process, would not be given substantial weight in the assignment process and would no longer be a factor in the evaluation process. Order execution quality data would be introduced as a factor in both the co-specialist assignment and evaluation processes and would be given substantial weight in the assignment process. The Commission believes that this change should help improve the quality of co-specialists serving on the CHX because it would require the CHX's Committee on Specialist Assignment and Evaluation ("CSAE") to make assignment and reallocation decisions based on objective, quantifiable performance criteria, rather than relying on the more subjective co-specialist questionnaire answers.

The proposed rule change also establishes a new process for evaluating co-specialists. Under this proposed evaluation process, on a quarterly basis, each co-specialist would be given an order execution quality score (derived from the execution quality data reported pursuant to Rule 11Ac1-5 under the Act<sup>7</sup>) and those co-specialists whose scores rank in the bottom 5% of all co-specialist scores would be required to participate in a special performance meeting with the CSAE. In the course of the special performance meeting, the CSAE would be permitted to take a variety of informal actions to encourage or assist the affected co-specialist. A special performance meeting could also be triggered by any of the factors considered in the assignment process (except the co-specialist questionnaire). If the informal actions from the special performance meeting do not result in improved co-specialist performance, the CSAE may conduct a formal hearing on the co-specialist's performance to determine whether to take action to reallocate the co-specialist's securities or suspend or terminate the co-specialist's registration in accordance with Rule 3, Article XVII of the CHX rules. In this regard, the Commission notes that a co-specialist may appeal the CSAE's decision by filing a request for review with the CHX's Executive

Committee under Rule 4, Article XVII of the CHX rules.

The Commission also notes that the proposed rule change strives to streamline the co-specialist questionnaire by reducing the range of rating scores and eliciting further responses for negative performance ratings. The Commission believes this change should make the questionnaires easier for brokers to complete and the responses to the questionnaires more useful to the CSAE. Therefore, the Commission finds that the proposed rule change is consistent with the Act.

*It is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act,<sup>8</sup> that the proposed rule change (SR-CHX-2004-10), as amended by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50025; File No. SR-DTC-2004-04]

### Self-Regulatory Organizations; The Depository Trust Company; Order Granting Approval of a Proposed Rule Change To Establish a Valued Delivery Order Interface With the National Securities Clearing Corporation

July 15, 2004.

#### I. Introduction

On May 3, 2004, The Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") proposed rule change File No. SR-DTC-2004-04 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposed rule change was published in the **Federal Register** on June 2, 2004.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is now granting approval of the proposed rule change.

#### II. Description

The National Securities Clearing Corporation ("NSCC") currently creates receive and deliver instructions for "Balance Order Securities" and for

"Special Trades" which NSCC members then have to manually enter into DTC as "Valued Delivery Orders" ("VDOs").<sup>3</sup> In connection with NSCC's project to update and revise its Continuous Net Settlement ("CNS") system ("CNS Rewrite"), NSCC requested DTC to establish an interface to automate and facilitate the processing and book-entry settlement of Balance Orders and Special Trades.<sup>4</sup>

DTC and NSCC currently have an automated VDO municipal bond interface known as the PDQ Automated Municipal Bond Settlement Facility ("PDQ Facility"). Pursuant to the PDQ Facility, NSCC members and NSCC municipal comparison only members ("MCOMs") that are also DTC participants ("common participants") or that clear through DTC participants may authorize NSCC to send to DTC their compared municipal bond transaction data in an automated file and may authorize DTC to accept and input such data as VDOs.

As a result of requests from common participants and based upon DTC's and NSCC's positive experience with the PDQ Facility, DTC and NSCC will expand the PDQ Facility to include all NSCC Balance Orders and Special Trades. The VDO Interface will automatically convey from NSCC to DTC VDO instructions for each common participant's Balance Orders and Special Trades pursuant to standing instructions given to NSCC by the common participant. For NSCC MCOMs that are not common participants, NSCC will create delivery versus payment VDO instructions for a MCOM's Special Trades if both the MCOM and its DTC clearing broker have each provided standing instructions to process such trades through the VDO Interface. The VDO Interface will incorporate the PDQ Facility's functionality and will replace the PDQ Facility.<sup>5</sup> DTC intends to implement the proposed rule change in conjunction with the implementation of NSCC's CNS Rewrite on or about August 6, 2004.<sup>6</sup>

<sup>3</sup> The terms Balance Order Securities and Special Trades are defined in Rule 1 of NSCC's Rules and Procedures. The term Valued Delivery Order refers to an order to deliver securities where delivery is to be made for payment as opposed to a Free Delivery which refers to an order to deliver securities free of any payment by the receiver.

<sup>4</sup> The Commission recently approved NSCC's CNS Rewrite. Securities Exchange Act Release No. 50026 (July 15, 2004) [File No. SR-NSCC-2004-01].

<sup>5</sup> Telephone conversation between Diane L. Brennan, Director of Risk Management, DTC, and staff of the Division of Market Regulation, Commission (May 21, 2004). Supplemented by letter from Diane L. Brennan, DTC (May 27, 2004).

<sup>6</sup> The date for implementation in the Notice has been adjusted. E-mail from Diane L. Brennan, DTC (June 23, 2004).

<sup>8</sup> 15 U.S.C. 78s(b)(2).

<sup>9</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> Securities Exchange Act Release No. 34-49777 (May 26, 2004), 69 FR 31149.

<sup>7</sup> 17 CFR 240.11Ac1-5.