

that the requested order should therefore be granted.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Margaret H. McFarland,**  
Deputy Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45643; File No. SR-Amex-2001-95]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, and 3 by the American Stock Exchange LLC Relating to Its Performance Evaluation Procedures for Option, Equity and ETF Specialists

March 25, 2002.

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> notice is hereby given that on February 19, 2001, the American Stock Exchange LLC ("Amex" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. On December 17, 2001, the Exchange submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On February 1, 2002, the Exchange submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> On February 19, 2002, the Exchange submitted Amendment No. 3 to the proposed rule change.<sup>5</sup> The

Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The Exchange proposes to amend Amex Rule 26, and adopt Commentaries .04, .05, .06, and .07 to Amex Rule 26 to for options, equity and Exchange Traded Fund ("ETF") specialists.

The text of the proposed rule change is available at the Office of the Secretary, the Amex, and at the Commission.

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

In its filing with the Commission, the Exchange 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. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

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

###### 1. Purpose

The Exchange's Allocations Committee is responsible for allocating securities to specialists that can do a quality job with respect to the functions of a specialist. The Committee on Floor Member Performance ("Performance Committee") reviews specialist performance and may take remedial action up to terminating a specialist's registration as such or reallocating securities when it identifies inadequate performance. The Exchange believes that these Committees protect the interests of investors, issuers and ETF sponsors by ensuring that only qualified specialists receive and retain allocations, and the institutional interests of the Exchange by ensuring

reflect the criteria that the Exchange will initially use to evaluate specialists. In addition, Amendment No. 3 clarifies that the Exchange will allocate weightings to the criteria, and notify specialists of these relative weightings before implementation. Amendment No. 3 also adds to the proposed rule text that the Exchange may change the criteria or weightings allocated to the criteria in order to enhance competitiveness relative to other markets and/or to improve market quality. Finally, Amendment No. 3 corrects typographical errors made in the proposed rule text.

that the Amex is as competitive as possible with other markets.<sup>6</sup>

We believe that the reallocation of a market maker's (or a specialist's) security due to poor performance is neither an action responding to a violation of an exchange rule nor an action where a sanction is sought or intended. Instead, we believe that performance-based security reallocations are instituted by exchanges to improve market maker performance and to ensure quality of markets. Accordingly, in approving rules for performance-based reallocations, we historically have taken the position that the reallocation of a specialist's or a market maker's security due to inadequate performance does not constitute a disciplinary sanction.

We believe that an SRO's need to evaluate market maker and specialist performance arises from both business and regulatory interests in ensuring adequate market making performance by its market makers and specialists that are distinct from the SRO's enforcement interests in disciplining members who violate SRO or Commission Rules. An exchange has an obligation to ensure that its market makers or specialists are contributing to the maintenance of fair and orderly markets in its securities. In addition, an exchange has an interest in ensuring that the services provided by its members attract buyers and sellers to the exchange. To effectuate both purposes, an SRO needs to be able to evaluate the performance of its market makers or specialists and transfer securities from poor performing units to the better performing units. This type of action is very different from a disciplinary proceeding where a sanction is meted out to remedy a specific rule violation. (Footnotes omitted.)

See also *In re James Niehoff and Company*, Administrative Proceeding File No. 3-6757, (November 30, 1986), and the other authorities cited in the Commission's *Post X-17* decision.

The Performance Committee may take remedial action on transactions that involve poor performance that are identified through Amex's surveillance or complaints. For equity securities, the Performance Committee currently reviews identified situations and "rates" transactions that involve inadequate

<sup>6</sup> See *In the Matter of the Application of Pacific Stock Exchange's Options Floor Post X-17*, Admin. Proc. File No. 3-7285, Securities Exchange Act Release No. 31666 (December 29, 1992), 51 SEC Dkt. 261. The Commission determined that performance evaluation processes fulfill a combination of business and regulatory interests at exchanges and are not disciplinary in nature. The Commission states in the *Post X-17* case:

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

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

<sup>3</sup> See Letter from Geraldine M. Brindisi, Vice President and Corporate Secretary, Amex, to Nancy J. Sanow, Esq., Assistant Director, Division of Market Regulation ("Division"), Commission (December 13, 2001) ("Amendment No. 1"). Amendment No. 1 adds specialist performance evaluation procedures for equity and ETF specialists to the proposed rule text and the purpose section of the proposal.

<sup>4</sup> See Letter from Geraldine M. Brindisi, Vice President and Corporate Secretary, Amex, to Nancy J. Sanow, Esq., Assistant Director, Division, Commission (January 31, 2002) ("Amendment No. 2"). Amendment No. 2 changes the proposed rule text, including the proposed Commentaries, from Rule 27 ("Allocations Committee") to Rule 26 ("Performance Committee"). In addition, Amendment No. 2 clarifies that the Exchange will assign weightings to each criterion used to evaluate specialists, and notify specialists of any changes to the criteria or the weightings used by the Exchange.

<sup>5</sup> See Letter from Geraldine M. Brindisi, Vice President and Corporate Secretary, Amex, to Nancy J. Sanow, Esq., Assistant Director, Division, Commission (February 14, 2002) ("Amendment No. 3"). Amendment No. 3 clarifies the rule text to

performance. At the end of each quarter, the Amex staff calculates a quarterly performance rating for each unit based upon the unit's rated situations. According to the Exchange, a poor rating may result in a preclusion on new allocations. The Performance Committee also conducts random reviews of option and ETF specialist order tickets and assigns performance ratings based upon these reviews.

The Allocations Committee thus receives "Performance Ratings," which Allocations Committee members use in making allocations decisions. The performance ratings consist of (1) a rating (from "1" to "5," with "1" being the best score) for each unit based upon a questionnaire distributed to Floor brokers on a routine basis (the Committee also receives the overall average score for each unit from the Floor Broker Questionnaire); and (2) a Performance Committee rating (from "1" to "5") based upon rated situations (for equities) and order ticket reviews (for options and ETFs).

In view of the importance of allocations and reallocation decisions to investors, issuers, ETF sponsors, and the Exchange, the Amex proposes to revise the current system for evaluating option, equity, and ETF specialists by adding a number of objective criteria to the rating scheme and implementing defined consequences for poor performance. The Exchange also proposes to codify its existing market share methodology for evaluating options specialist performance. The Exchange notes that upon implementation of the new evaluation system for equity specialists, the Performance Committee will no longer assign performance ratings for specific transactions, but may take such other action as is available to the Performance Committee and appropriate in the circumstances. The Exchange will continue order ticket reviews for options and ETFs for regulatory purposes. The Exchange may incorporate the results of these reviews into the performance evaluation rating system with the criteria that measure the number of Minor Floor Violation Disciplinary actions.

Under the proposed specialist evaluation systems, specialists would be evaluated quarterly based upon data from the prior quarter with respect to various criteria. The Exchange proposes that it may change the criteria used to evaluate specialists and the weightings of these criteria from time to time as warranted by market conditions in order to enhance the Exchange's competitiveness relative to other markets and/or market quality. The Exchange would notify specialists of

any changes to the criteria, and the weightings thereof, prior to implementation. The Exchange proposes to use the following performance criteria at the commencement of the specialist evaluation systems:

#### **Option Specialist Evaluation Criteria**

- Percentage of trades executed at or better than the National Best Bid and Offer ("NBBO")
- Percentage of orders that receive price improvement
- Percentage of time at NBBO
- Average bid/offer spread
- Liquidity enhanced trades<sup>7</sup>
- Average execution time
- Size of orders eligible for Auto-Ex
- Timeliness of openings relative to the underlying security
- Floor Broker Questionnaire rankings
- Average number of Performance Committee actions per option, and
- Average number of Minor Floor Violation Disciplinary Committee actions<sup>8</sup> per option.

#### **Equity Specialist Evaluation Criteria**

- Percentage of volume executed better than the NBBO
- Percentage of volume at the NBBO
- Percentage of time at the NBBO
- Percentage of market orders executed within sixty seconds
- Percentage of manual display of better limit orders
- Number of issues opened after 9:45
- Floor Broker Questionnaire rankings
- Average response time to ITS<sup>9</sup> commitments

#### **ETF Specialist Evaluation Criteria**

- Percentage of orders that receive price improvement
- Percentage of time at the NBBO
- Average bid/offer spread
- Average execution time for market and marketable limit orders
- Floor Broker Questionnaire rankings
- Average response time to ITS commitments

<sup>7</sup> The Exchange notes that liquidity enhancement is a measure of the depth of a market. The percentage of trades that receive liquidity enhancement equals the percentage of trades where an order for more than 20 contracts was executed at one price, at or between the NBBO.

<sup>8</sup> The Exchange represents that the term "action" would be defined to include any time the Committees did something other than "no action" the matter. For example, an admonitory letter from the Performance or Minor Floor Violation Disciplinary Committee would be considered "action" for the purposes of calculating specialist performance ratings.

<sup>9</sup> The term "ITS" means Intermarket Trading System.

- Average number of Performance or Minor Floor Violation Disciplinary Committee actions per ETF

The Exchange would rate all specialists from "1" to "5" on a curve based upon their scores with respect to the criteria. ETFs would be "tiered" and evaluated for rating purposes in separate groups based upon trading volume to ensure that comparisons between specialists are based upon securities with similar trading characteristics. The Exchange would notify specialists of their ratings following calculation. A rating of "1" would represent the best possible score. Ratings of "4" and "5" would have defined remedial consequences.

A specialist unit that received a "4" or a "5" rating in any quarter would be referred to the Performance Committee for consideration of a preclusion on new allocations, or other appropriate remedial action. A specialist unit that received a "5" rating in any two of four consecutive quarters would be referred to the Performance Committee for consideration of possible reallocation of one or more securities, or other appropriate remedial action. A specialist unit that received ratings of "4" or "5" in any three of six consecutive quarters would be referred to the Performance Committee for consideration of possible reallocation of one or more securities, or other appropriate remedial action. The Exchange notes that the Performance Committee may consider any relevant information, including the Specialist Floor Broker Questionnaire, trading data, a member's regulatory history, market share, order flow statistics, level and adequacy of staffing, and other pertinent information in reviewing a specialist or unit.

In addition to the performance ratings system described above, the Exchange also proposes to codify the current program for evaluating options specialists based upon market share. Under this program, options specialists are regularly evaluated with respect to non-market maker contract volume in options that are actively traded in the United States. There may be different minimum market share criteria for (1) options that have always been multiply listed, and (2) options that were at one time exclusively awarded to only one exchange under the old "lottery" system.

According to the Exchange, options specialists are not evaluated on their market share in a newly listed option for the six months following listing on the Exchange. Under the program, a specialist that falls below the minimum market share criteria in one or more

options is referred to the Performance Committee for consideration of reallocation or other remedial action based upon poor market share in one or more options. The Exchange may change the minimum market share criteria used to evaluate specialists from time to time as warranted by market conditions. The Exchange would notify specialists of any changes to the market share criteria prior to implementation. The Exchange also would notify specialists of their market share.

The market share evaluation program for options specialists would be separate from the performance ratings system. Thus, for example, an option specialist with performance ratings that would not trigger remedial action could be referred to the Performance Committee for consideration of reallocation or other action based upon sub-standard market share in one or more options.

The Performance Committee reviews proposed transfers of specialist registrations between specialists to ensure that the institutional interests of the Exchange are protected. The Performance Committee, accordingly, will consider the performance ratings and market share of both the acquiring and transferring specialists in determining whether to approve a proposed transfer.

Under the proposed specialist evaluation procedures, performance reviews can result from (1) complaints or surveillance reviews, (2) low scores under the specialist performance ratings systems, or (3) low market share in one or more options classes. A performance review can result in a variety of possible actions, including recommendations for performance improvement, a determination not to permit a firm to seek new allocations, or a reallocation of one or more options classes from a specialist unit. The Performance Committee is not precluded from reallocating options based on a single instance of deficient performance or a single quarter or poor ratings or low market share. Conversely, the Performance Committee is not required to take such actions. Rather, the Exchange believes that the purpose of the rules and processes is to identify circumstances that warrant review by the Performance Committee. The nature of the appropriate remedial actions is necessarily a subjective matter, dependent on such matters as the options being traded, competition on other exchanges, personnel and systems changes, and other factors. Accordingly, such determinations are left to the expertise, discretion and judgment of the Performance Committee.

## 2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with section 6(b)(5) of the Act<sup>10</sup> in general, and furthers the objectives of section 6(b) of the Act<sup>11</sup> in particular, in that the proposal is designed to promote just and equitable principles of trade and protect investors and the public interest by encouraging good performance and competition among specialists.

### *B. Self-Regulatory Organization's Statement on Burden on Competition*

The Exchange believes that the proposed rule change will impose no burden on competition; rather, it will enhance and encourage competition both within the Exchange, and, more significantly, between and among the Exchange and other exchanges and markets by establishing incentives for superior performance and thereby ensuring the maintenance of quality markets at the Exchange. In this respect, the Exchange believes that it is critical to recognize that the most important level of competition occurs not among specialists of the same exchange to obtain a particular listing, but rather among specialists of different exchanges trading in the same security and actively competing for the business of the investing public. The Exchange notes that the Commission has expressly recognized that the procedures set forth in the proposed rule change for reviewing the performance of specialists and taking remedial action where appropriate are necessary to ensure quality markets and thereby attract buyers and sellers to the Exchange.<sup>12</sup>

### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants or Others*

No written comments were solicited or received with respect to the proposed rule change.

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

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange.

All submissions should refer to File No. SR-Amex-2001-95 and should be submitted by April 22, 2002.

**Margaret H. McFarland,**  
*Deputy Secretary.*

For the Commission, by the Division of Market Regulation, pursuant to the delegated authority.<sup>13</sup>

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## SECURITIES AND EXCHANGE COMMISSION

[Release No.34-45642; File No. SR-CSE-2002-03]

### **Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Cincinnati Stock Exchange, Inc. Relating to Changes in Transaction Fees and Establishing a Pilot Revenue Sharing Program for Trading in Nasdaq National Market Securities**

March 26, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on March 25, 2002, the Cincinnati Stock Exchange, Incorporated ("CSE" or "Exchange") filed with the Securities and Exchange Commission

<sup>10</sup> 15 U.S.C. 78f.

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>12</sup> See note 6, *supra*.

<sup>13</sup> 17 CFR 200.30-3(a)(12).

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