

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38828; File No. SR-NYSE-97-12]

Self-Regulatory Organizations; the New York Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change Relating to Amendments to the Exchange's Allocation Policy and Procedures

July 9, 1997.

I. Introduction

On April 16, 1997, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to amend the Exchange's Allocation Policy and Procedures.

The proposed rule change was published for comment in Securities Exchange Act Release No. 38669 (May 22, 1997), 62 FR 29170 (May 29, 1997). No comments were received on the proposal.

II. Background

The Exchange's Allocation Policy and Procedures govern the allocation of equity securities to NYSE specialist units. The Allocation Committee has sole responsibility for the allocation of securities to specialist units pursuant to Board-delegated authority, and is overseen by the Quality of Markets Committee of the Board of Directors. The Allocation Committee renders decisions based upon the allocation criteria specified in the Allocation Policy.

In its proposal, the NYSE states that the intent of the Exchange's Allocation Policy and Procedures is: (1) To ensure that securities are allocated in an equitable and fair manner and that all specialist units have a fair opportunity for allocations based on established criteria and procedures; (2) to provide an incentive for ongoing enhancement of performance by specialist units; (3) to provide the best possible match between a specialist unit and a security; and (4) to contribute to the strength of the specialist system. In September 1987, the Quality of Markets Committee ("QOMC") appointed the first Allocation Review Committee ("ARC") to undertake a comprehensive review of the Exchange's then-existing allocation procedures which had been in effect

since 1976. ARC's recommendations were filed with the SEC in 1988 and approved in 1990.³ In April 1991, the QOMC determined that the Allocation Policy and Procedures should be re-examined and appointed a new committee, ARC II, to do so. The Committee's recommendations were subsequently filed with the Commission, and approved in 1993 as a one-year pilot.⁴ In August 1994, the Exchange filed for and subsequently received permanent approval of that pilot.⁵ In accordance with the Exchange's commitment to preserve the integrity of the existing allocation system while refining the allocation policy as necessary, ARC III convened in November 1993. The Committee's recommendations were filed with the Commission, and approved in September 1994.⁶ In December 1995, the QOMC appointed ARC IV to continue to review the allocation process. The Committee made several recommendations with respect to the Allocation Policy and Procedures. Several of these recommendations were submitted by the Exchange for immediate effectiveness in March 1997 for a seven-month pilot period.⁷ Additional recommendations of ARC IV are contained in this filing.

III. Description of Proposal

The NYSE proposes to amend Part IV, Allocation Criteria, of its Allocation Policy and Procedures with respect to the Specialist Performance Evaluation Questionnaire ("SPEQ"), objective measures of performance, allocation applications, and disciplinary and cautionary data.

With respect to the Exchange's SPEQ,⁸ the NYSE proposes that in considering whether a stock will be assigned to a particular specialist unit, the Allocation Committee shall give 25% weight to the results of the SPEQ.

³ Securities Exchange Act Release No. 27803 (Mar. 14, 1990), 55 FR 10740 (Mar. 22, 1990) (order approving File No. SR-NYSE-88-32).

⁴ Securities Exchange Act Release No. 33121 (Oct. 29, 1993), 58 FR 59085, (Nov. 5, 1993) (order approving File No. SR-NYSE-92-15).

⁵ Securities Exchange Act Release No. 34906 (Oct. 27, 1994), 59 FR 55142 (Nov. 3, 1994) (order approving File No. SR-NYSE-94-30).

⁶ Securities Exchange Act Release No. 34626 (Sept. 1, 1994), 59 FR 46457 (Sept. 8, 1994) (order approving File No. SR-NYSE-94-18).

⁷ Securities Exchange Act Release No. 38373 (Mar. 7, 1997), 62 FR 13421 (Mar. 20, 1997) (notice of filing and immediate effectiveness of File No. SR-NYSE-97-04).

⁸ The SPEQ is a quarterly survey on specialist performance completed by eligible floor brokers (i.e., any floor broker with at least one year of experience). The SPEQ consists of 21 questions and requires floor brokers to rate, and provide written comments on, the performance of specialist units with whom they deal frequently.

Currently, the policy only requires the Allocation Committee to consider no more than 25% of the SPEQ results.

With respect to the objective measures of performance used by the Allocation committee in considering whether to assign a stock to a particular unit, the NYSE proposes to add two criteria, capital utilization and near neighbor analysis. Capital utilization measures the degree to which the specialist unit uses its own capital in relation to the total dollar value of trading in the unit's stocks, while the near neighbor analysis measures specialist performance and market quality by comparing performance in a stock to performance of stocks that have similar market characteristics. The Commission had previously approved the use of these criteria in allocation decisions, but these criteria had never been codified into the actual language of the allocation policy and procedures.⁹

With respect to allocation applications, the NYSE proposes that in their applications for the allocation of a listing company's stock, specialist units describe all pertinent factors as to why they believe they should be allocated the stock, which shall include how the unit will allocate resources (staff and/or capital) to accommodate this new issue and what new resources, if any, the specialist unit will meet to acquire to service this stock. The NYSE proposes to delete the language requiring a description of the specialist unit's capital base.

With respect to the reporting of disciplinary actions, the NYSE proposes to amend its allocation policy and procedures such that enforcement actions would be reported to the Allocation Committee when an enforcement case is authorized, rather than when the stipulation is signed or charges are issued, as is currently required. Moreover, if formal disciplinary action is ultimately taken, the item would remain in the file for 12 months after a Hearing panel decision is final, rather than six months, as is currently required. In addition, the current policy interpretation that summary fines, not just cautionary letters, for market maintenance are reported for 12 months, would be codified.

The NYSE also proposes to amend Part V, Policy Notes, of its Allocation Policy and Procedures with respect to mergers of listed and unlisted companies, targeted stock, allocation "freeze" policy, allocation "sunset"

⁹ Securities Exchange Act Release No. 38158 (Jan. 10, 1997), 62 FR 2704 (Jan. 17, 1997).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

policy, and criteria for applicants that are not currently specialists.

With respect to mergers of listed and unlisted companies, the NYSE proposes to amend its allocation policy and procedures to allow a company that results from the merger between a listed company and an unlisted company to remain registered with the specialist unit that had traded the listed company. Under the proposal, however, if the unlisted company is determined to be the survivor-in-fact, the unlisted company may request that the Allocation Committee reallocate the stock of the unlisted company. In this case, all specialist units would be invited to apply, except that the Allocation Committee shall honor the unlisted company's request not to be allocated to the specialist unit that had traded the listed company's stock. Currently, companies resulting from mergers of listed and unlisted companies must remain registered with the specialist for the listed company regardless of whether the unlisted company is the survivor-in-fact.

With respect to targeted stock, the NYSE proposes that when such a security is "uncoupled" and becomes an independently entity, the targeted stock would remain registered with the current specialist in the listed company. Under the proposal, however, the listed company may request that the Allocation Committee reallocate the targeted stock of the listed company. In this case, all specialist units would be invited to apply, except that the Allocation Committee shall honor the listed company's request that the targeted stock not be allocated to the specialist unit that had traded the target stock. In its filing, the NYSE notes that there is no current policy for allocating targeted stock.

The NYSE proposes to codify into its Allocation Policy and Procedures its allocation freeze policy, which provides that a specialist firm may not apply to be allocated a stock following reallocation of a stock or voluntary withdrawal of registration in a stock as a result of an Exchange disciplinary proceeding. Specifically, in the event that a specialist unit: (i) loses its registration in a specialty stock as a result of proceedings under Exchange Rules 103A, 475 or 476; or (ii) voluntarily withdraws its registration in a specialty stock as a result of possible proceedings under those rules, the specialist unit would be ineligible to apply for future allocations for the six month period immediately following the reassignment of the security. Following this initial six month period, a second six month period will begin

during which a specialist unit may apply for new listings, provided that the unit demonstrates to the Exchange relevant efforts taken to resolve the circumstances that triggered the prohibition. Under the allocation freeze policy, the determination as to whether a unit may apply for new listings will be made by Exchange staff, in consultation with the Floor Directors. The factors the Exchange will consider will vary depending on the specialist unit's particular situation, but may include whether the specialist unit has: Implemented more stringent supervision and new procedures; enhanced back-office staff; attained appropriate dealer participation; changed professional staff; and supplied additional manpower and experience.

With respect to the allocation "sunset" policy, the NYSE proposes that allocation decisions remain effective with respect to any initial public offering companies that list within three months. Under the proposal, if a listing company does not list within three months, the matter shall be referred again to the Allocation Committee and applications invited from all specialist units. The NYSE notes that previously it had followed a one-year sunset policy.

With respect to the criteria for applicants that are not currently specialists, the NYSE proposes to add a provision requiring that the Allocation Committee consider, in addition to capital or operational problems, any action taken or warning issued within the past 12 months by any regulatory or self-regulatory organization against the unit or any of its participants with respect to any regulatory or disciplinary matter. Currently, the policy only requires consideration of those disciplinary matters or warnings related to any Floor-related activity.

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b).¹⁰ In particular, the Commission believes the proposal is consistent with the Section 6(b)(5) requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest. Further, the Commission finds that the proposal also is consistent with Section 11(b) of the

Act¹¹ and Rule 11b-1¹² thereunder, which allow exchanges to promulgate rules relating to specialists to ensure fair and orderly rules relating to specialists to ensure fair and orderly markets.

Specialists play a crucial role in providing stability, liquidity and continuity to the trading of securities. Among the obligations imposed upon the specialists by the Exchange, and by the Act and the rules thereunder, is the maintenance of fair and orderly markets in their designated securities.¹³ To ensure that specialists fulfill these obligations, it is important that the Exchange develop and maintain stock allocation procedures and policies that provide specialists with an initiative to strive for optimal performance.

The Commission believes that the Exchange's proposal to amend Part IV, Allocation Criteria, of its Allocation Policy and Procedures is consistent with the Act for the reasons set forth below.

As described above, the proposal will require the Allocation Committee to give 25% weight to the results of the SPEQ in determining whether to allocate a stock to a particular specialist unit. Under the current Allocation Policy, the SPEQ is to be given no more than 25% weight in allocation decisions. The Commission believes that this change will provide certainty to the Allocation Committee on what portion of its decision should be based on the SPEQ and will ensure that allocation decisions are based in sufficient part on specialist performance. In this regard, the Commission continues to believe that performance, as measured by the objective criteria, should be the primary consideration of the Allocation Committee.

Although the SPEQ remains a useful tool to measure performance, as noted above, the Commission believes that objective measures of performance should play an important role in allocation decisions. In particular, the Commission has previously stated its belief that objective performance measures can identify poor market making performance that otherwise may not be reflected in a specialist unit's SPEQ survey results.¹⁴ In this regard, the Commission believes it is appropriate to codify into NYSE's Allocation Policy and Procedures capital utilization and near neighbor analysis as objective measures of performance to be considered by the

¹¹ 15 U.S.C. 78f(b)(5).

¹² 17 CFR 240.11b-1.

¹³ See 17 CFR 240.11b-1; NYSE Rule 104.

¹⁴ Securities Exchange Act Release No. 33369 (Dec. 22, 1993), 58 FR 69431 (Dec. 30, 1993).

¹⁰ 15 U.S.C. 78f(b).

Allocation Committee in making their allocation decisions.¹⁵ Specifically, the Commission has previously stated its belief that these quality market measures identify aspects of market making that are directly relevant to the specialist's maintenance of fair and orderly markets. The Commission continues to believe that the near neighbor analysis and capitalization measures could assist the Allocation Committee in allocating stocks to specialists who commit their own capital to maintain stable and liquid markets and, thus, believes codification of such measures into the NYSE's Allocation Policy and Procedures is appropriate.

By requiring specialist units to include in their applications for the allocation of a listing company's stock a description of how the specialist unit will allocate resources (staff and/or capital) to accommodate this new issue and what new resources, if any, the specialist unit will need to acquire to service this stock, the Commission believes that the proposal will provide the Allocation Committee with the necessary information to better determine which specialist unit is best equipped to handle trading of a particular stock. Moreover, by requiring that enforcement actions against specialists be reported to the Allocation Committee when an enforcement case is authorized, rather than later when the stipulation is signed or charges are issued, the proposal should ensure that relevant information about enforcement matters considered on a timely basis by the Allocation Committee. Similarly, by requiring that records of formal disciplinary action be retained for 12 months, rather than the current six months, after a Hearing Panel decision is final, the proposal should enhance the allocation process by providing the Allocation Committee with relevant information over a longer period of time.

The Commission believes that the Exchange's proposal to amend Part V, Policy Notes, of its Allocation Policy and Procedures also is consistent with the Act for the reasons set forth below.

The Commission believes that the NYSE's proposal to allow a company, resulting from a merger between a listed company and an unlisted company, to request that the Allocation Committee reallocate the stock of the unlisted

company so long as the unlisted company is determined to be the survivor-in-fact is appropriate because the merged company is more analogous to a new company that has never been listed. The proposal also requires the Allocation Committee to honor the unlisted company's request the Allocation Committee to honor the unlisted company's request not to be allocated to the specialist unit that had traded the listed company's stock. This is also currently permitted in situations involving spin-offs, listings of related companies, and relistings. Although barring the original specialist unit from receiving the listing does raise some concerns about ensuring that all specialist units will be allowed to compete for the allocation on an equal basis, the Commission believes that there may be legitimate reasons why an unlisted company may believe it is more appropriate to be allocated to a new specialist unit rather than one that had dealings with the former listed company. Accordingly, the Commission finds this provision is reasonable under the Act. For the same reasons, the Commission believes that the NYSE's proposal to allow a listing company, whose targeted stock becomes listed separately, the request that the Allocation Committee reallocate the targeted stock and refrain from allocating the targeted stock to the specialist unit that had traded the targeted stock is reasonable.

The Commission also believes that by codifying its allocation freeze policy, which provides that a specialist unit may not apply to be allocated a stock following reallocation of a stock or voluntary withdrawal of registration in a stock as a result of an Exchange disciplinary proceeding, the proposal provides an incentive to specialists to improve their performance or maintain superior performance while also ensuring that only those units performing well and likely to make good markets in a particular stock will receive allocations.

The Commission also believes that the NYSE's allocation sunset policy, requiring allocation decisions to remain effective for three months with respect to any initial public offering ("IPO") listing and, in the event a listing company does not list within three months, requiring that the matter be referred again to the Allocation Committee, with applications invited from all specialist units, is appropriate. The Commission recognizes that, after three months, the specialist unit assigned to make a market in the initial public offering listing company may no longer have the resources to make the

best market and it would be prudent for the Allocation Committee to reevaluate its allocation decision. The prior policy of waiting one full year before an IPO was reallocated to another unit was, in the Commission's view, too long and did not allow the Allocation Committee to take into account changes in the unit that may have occurred during the one year.

The Commission also believes that in considering the allocation application of an applicant that is not currently a specialist, the NYSE's proposal to add a provision requiring that the Allocation Committee consider, in addition to capital or operational problems, any action taken or warning issued within the past 12 months by any regulatory or self-regulatory organization against the unit or any of its participants will help to strengthen the allocation policy and ensure that only the best units are allocated stocks. Currently, the policy only requires consideration of those disciplinary matters or warnings related to any Floor-related activity. The Commission believes that this expansion to include any regulatory or disciplinary matters will ensure the quality of specialists assigned to make markets in NYSE-listed stocks.

In summary, the Commission believes that the Exchange's Allocation Policy and Procedures can serve as an effective incentive for specialist units to maintain high levels of performance and market quality in order to be considered for, and ultimately awarded, additional listings. This in turn can benefit the execution of public orders and promote competition among the exchanges. In this regard, the Commission believes that the NYSE's proposals related to its Allocation Policy and Procedures help to further these purposes. The Commission will continue to support the NYSE's efforts to develop a meaningful and effective allocation policy and procedures that encourage improved specialist performance and market quality.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁶ that the proposed rule change (SR-NYSE-97-12) is approved.

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

Margaret H. McFarland,
Deputy Secretary.

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¹⁵ The Commission previously approved the consideration of specialist near neighbor analysis and capital utilization by the Allocation Committee. Release No. 38158, *supra* note 9. Today, the Commission is merely approving the codification of such measures into the NYSE's Allocation Policy and Procedures.

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ 17 CFR 200.30-(a)(12).