

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

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Secretary.

[FR Doc. E6-13401 Filed 8-15-06; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54291; File No. SR-BSE-2006-30]

### Self-Regulatory Organizations; Boston Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change Relating to the Implementation of the Second Phase of the Boston Equities Exchange ("BeX") Trading System

August 8, 2006.

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 August 3, 2006, the Boston Stock Exchange ("BSE" or "Exchange") 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 by the BSE. 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

In previous rule filings, BSE proposed to establish the governance framework for a new electronic trading facility, as that term is defined in Section 3(a)(2) of the Act,<sup>3</sup> which is to be called BeX,<sup>4</sup> and to propose rules that pertain to the first phase of BeX.<sup>5</sup> The first phase of the BeX trading system involves a fully automated electronic book for the display and execution of orders in securities listed otherwise than on The

Nasdaq Stock Market for which the BSE obtains unlisted trading privileges ("UTP") after June 30, 2006.

The proposed rules set forth below are being filed in connection with the implementation of the second phase of the BeX trading system. As of January 1, 2007, there will no longer be any specialist participation in any transactions on the BSE or otherwise. Additionally, in connection with satisfying the requirements of Regulation NMS, the BSE is proposing eight new order types; rules to prevent locked or crossed quotations; a new order routing system; and an order protection rule. The text of the proposed rule change is available on Exchange's Web site (<https://www.bostonstock.com>), at the Exchange's Office of the Secretary, and at the Commission's Public Reference Room.

The text of the proposed rule change also appears below. Proposed new language is italicized; deleted language is in [brackets].<sup>6</sup>

#### Rules of the Boston Stock Exchange Chapter XXXVII—Boston Equities Exchange ("BeX") Trading System

The Boston Equities Exchange ("BeX") trading system is a fully-automated facility of the Exchange, which allows eligible orders in eligible securities to electronically match and execute against one another.

##### Section 1. BeX Eligible Securities

(a) Eligible Securities. All securities eligible for trading on the Exchange [that are listed otherwise than on The Nasdaq Stock Market for which the BSE obtains unlisted trading privileges ("UTP") after June 30, 2006] shall be eligible for trading through BeX. Any specialist request to remove a security from BeX shall be considered by the appropriate Board Committee.

##### Section 2. Eligible Orders

Subsections (a) through (b)—no change.

(c) Eligible order types:

(i) Orders eligible for execution in BeX may be designated as one of the following existing BSE order types as defined in Chapter I, Section 3 except that any reference in the existing BSE Rules to the execution of Orders as soon as "represented at the specialist's post" shall for purposes of this Section be understood to mean "entered in BeX":

- (A) At the Opening or At the Opening Only Order.
- (B) Day Order.
- (C) Do Not Increase (DNI).
- (D) Do Not Reduce (DNR).
- (E) Fill or Kill.
- (F) Good 'Till Cancel Order.
- (G) Immediate or Cancel.
- (H) Limit, Limited Order or Limited Price Order.
- (I) At the Close.
- (J) Market Order.
- (K) Stop Limit Order.
- (L) Stop Order.

With the exception of Fill or Kill and Immediate or Cancel Orders, a customer may append to an Order an instruction that the Order be routed to the market(s) displaying the National Best Bid or Offer if the Order would trade through the National Best Bid or Offer if executed on the BeX. *Absent such an instruction, the order will be cancelled.*

(ii) Orders eligible for execution in BeX may also be designated as one of the following additional order types:

(A) "Cross": An order to buy and sell the same security at a specific price better than the best bid and offer displayed in BeX and equal to or better than the National Best Bid and Offer. A Cross Order may represent interest of one or more BSE Members.

(B) "Cross with Size": A Cross Order to buy and sell at least 5,000 shares of the same security with a market value of at least \$100,000.00 (i) at a price equal to or better than the best bid or offer displayed in BeX and the National Best Bid or Offer and (ii) where the size of the order is larger than the *largest order* [aggregate size of all interest] displayed in BeX at that price.; and (iii) where neither side of the order is for the account of the BSE Member sending the order to BeX.]

(C) "Good 'Till Date (GTD)": An order to buy or sell that, if not executed, expires at the end of date specified in the order.

(D) "Good 'Till Time (GTT)": An order to buy or sell that, if not executed, expires at the time specified in the order.

(E) "Limit or Close": A limit order to buy or sell that if not executed prior to the Market on Close cutoff time of 3:40 p.m., pursuant to Chapter II, Section 22, will automatically convert to an At the Close Order for inclusion in the closing process and if not so executed, at the close, will be cancelled.

(F) "Mid-Point Cross": A two-sided order with both a buy and sell component combined that executes at the midpoint of the National Best Bid or Offer. A Mid-point Cross Order will be rejected when a locked or crossed

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

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

<sup>3</sup> Under the Act, the "term 'facility' when used with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service." See 15 U.S.C. 78c(a)(2).

<sup>4</sup> See Securities Exchange Act Release No. 54035 (June 22, 2006), 71 FR 37135 (June 29, 2006) (SR-BSE-2006-20) ("BeX Governance Filing").

<sup>5</sup> See Securities Exchange Act Release No. 54034 (June 22, 2006), 71 FR 37140 (June 29, 2006) (SR-BSE-2006-22) ("BeX Facility Filing").

<sup>6</sup> For clarity, the rule text below treats the rule text proposed in the BeX Facility Filing as existing rule text even though that filing has not been approved by the Commission.

market exists in that security at the time the Order is received. Midpoint Cross Orders may be entered, quoted, executed and reported in increments as small as one-half of the Minimum Price Variation.

(G) "Reserve": A Limit Order with a portion of the size displayed and with a reserve portion of the size that is not displayed. A Reserve Order cannot be an IOC Order or Market Order.

(H) "Minimum Quantity": A Minimum Quantity Order is an order subject to the provisions of Chapter XXXVII, Section 6, that, upon entry, must be executed at least at its minimum quantity or it will be cancelled. If executed in part, the remaining quantity remains in the book and follows the execution rule of the order type. A Stop Limit Order can be a Minimum Quantity Order and, at the election of the order, will be handled pursuant to subsection (j) of Section 3.

(I) "Preferred Price Cross": A Two-Sided Cross Order with a preferred limit price and an optional preferred tick, both set by the Member. A preferred limit price is the limit price the two-sided cross order will be executed at if it is equal to or better than the National Best Bid or National Best Offer ("Preferred Limit Price"). The optional preferred tick is the amount of ticks beyond the preferred limit price at which the two-sided cross order may be executed ("Optional Preferred Tick"). The Preferred Price Cross order cannot be executed at a price that is more than the preferred limit price plus the amount of optional preferred ticks or less than the preferred limit price minus the amount of optional preferred ticks. If the Preferred Price Cross cannot be executed at the Preferred Limit Price the execution price of the Cross will be determined by the Trading System to be the closest price to the Preferred Limit Price, respecting the Optional Preferred Tick and the National Best Bid or National Best Offer.

(J) Best Price Intermarket Sweep Order ("BPISO"): A Best Price Intermarket Sweep Order (BPISO) is an order marked as required by SEC Rule 600(b)(30) that is to be executed against any orders at the Exchange's Best Bid or Best Offer (including any undisplayed orders at that price) as soon as the order is received by BSE, with any unexecuted balance of the order to be immediately cancelled. BSE, in executing the BPISO, shall not take any of the actions described in Chapter XXXVIII, Section 4 to prevent an improper trade through.

(K) Automated Immediate or Cancel ("AIOC"): An automated immediate or cancel order received on BSE will execute immediately and automatically,

either in whole or in part, at or better than its limit price, with any unexecuted balance of the order to be immediately cancelled. The unexecuted portion of the order will not be routed to another Trading Center.

(L) "Price-Penetrating ISO": An order marked as required by SEC Rule 600(b)(30) that is to be executed at or better than its limit price as soon as the order is received by BSE, with any unexecuted balance of the order to be immediately cancelled. Orders marked as price-penetrating ISO shall be executed against any eligible orders in BSE (including any undisplayed orders, through multiple price points). BSE, in executing these orders, shall not take any of the actions described in Chapter XXXVIII, Section 4 to prevent an improper trade-through.

(M) ISO Cross Order: A two sided order that, upon receipt, will be executed without any action on the part of the Exchange to prevent an improper trade through. The Member submitting an ISO Cross is responsible for checking all protected quotes and must send one or more ISO orders to other Trading Centers displaying a price better than the cross price.

(N) Cancel on Corporate Action: In the event of a dividend, distribution or stock split ("Corporate Action"), the order in the limit book will be cancelled.

Subsection (d)—no change.

#### \* \* \* Interpretations and Policies

.01 The terms "Best Bid" and "Best Offer" shall mean, respectively, the highest and lowest priced order to buy and sell an eligible security in BeX.

.02 The terms "National Best Bid" and "National Best Offer" shall mean, respectively, the highest and lowest priced order or quote to buy and sell a BeX eligible security displayed in the consolidated quotation system for the security.

#### Section 3. Operation of BeX

Subsections (a)–(f)—no change.

(g) Post-Primary Trading Session (PPS). The BeX PPS will operate from the time when the primary market disseminates its closing price until [4:30] 6:30 p.m. During the BeX PPS only cross orders at a specific price may be submitted.

Subsection (h)—no change.

(i) Ranking and Display of Orders

(i)–(ii)—no change

(iii) The displayed portion of Reserve Orders (not the reserve portion) shall be ranked at the specified limit price and the time of order entry. If the displayed portion of the Reserve Order is decremented such that fewer than 100 shares are displayed, the displayed

portion of the Reserve Order shall be replenished for: a) The displayed amount; or b) the entire reserve amount, if the remaining reserve amount is smaller than the displayed amount. Upon replenishment the reserve portion shall be submitted and ranked at the specified limit price and time of replenishment.

(iv) Except as otherwise permitted by Section 3, paragraphs (v)–(vi) below, all orders at all price levels on BeX shall be displayed to all Members on an anonymous basis and transactions executed on BeX will be processed anonymously. The transaction reports will indicate the details of the transaction, but will not reveal contra party identities.

(v) BeX will reveal the identity of a Member in the following circumstances:

(A) For regulatory purposes or to comply with an order of a court or arbitrator;

(B) When the National Securities Clearing Corporation ("NSCC") ceases to act for a Member or the Member's clearing firm, and NSCC determines not to guarantee the settlement of the Member's trades; or

(C) On risk management reports provided to the contra party of the Member or Member's clearing firm each day by 4 p.m. (E.S.T.) which disclose trading activity on the aggregate dollar value basis.

(vi) In order to satisfy Members' record keeping obligations under SEC Rules 17a-3(a)(1) and 17a-4(a), BSE shall retain for the period specified in Rule 17a-4(a) the identity of each Member that executes an anonymous transaction described in paragraph (i)(iii) of this rule. The information shall be retained by BeX in its original form or a form approved under Rule 17a-6. Members shall retain the obligation to comply with SEC Rule 17a-3(a)(1) and 17a-4(a) whenever they possess the identity of their contra party.

#### Interpretations and Policies:

.01 No Member having the right to trade through the facilities of BeX and who has been a party to or has knowledge of an execution shall be under obligation to divulge the name of the buying or selling firm in any transaction.

.02 Except as required by paragraphs (v)–(vi), no Member shall transmit through the facilities of BeX any information regarding a bid, offer, other indication of an order, or the Member's identity, to another Member until permission to disclose and transmit such bid, offer, other indication of an order, or the Member's identity has been obtained from the originating

Member or the originating Member affirmatively elects to disclose its identity.

Subsections (j) through (k)—no change.

#### **Section 4. Cancellation of Transactions**

Subsection (a)—no change.

#### **Section 5. Handling of Clearly Erroneous Transactions**

Subsection (a)—no change.

#### **Section 6. Orders To Be Reduced and Increased on Ex-Date**

Subsections (a) through (d)—no change.

#### **Section 7. Application of BSE Rules**

Subsection (a)—no change.

#### *Section 8. Approval of Market Makers*

(a) No Member shall act as a Market Maker in any security unless such Member has been approved as a Market Maker in such security by the Exchange pursuant to this Section and the Exchange has not suspended or canceled such approval. Approved Market Makers are designated as dealers on the Exchange for all purposes under the Securities Exchange Act of 1934 and the rules and regulations thereunder.

(b) An applicant shall file an application for Market Maker status on such form as the Exchange may prescribe. Applications shall be reviewed by the Exchange, which shall consider such factors including, but not limited to capital operations, personnel, technical resources, and disciplinary history.

(c) An applicant's Market Maker status shall become effective upon receipt by the Member of notice of an approval by the Exchange. In the event that an application is disapproved by the Exchange, the applicant shall have an opportunity to be heard upon the specific grounds for the denial, in accordance with the provisions of Chapter XXX of the BSE Rules.

(d) A Market Maker may be suspended or terminated by the Exchange upon a determination of any substantial or continued failure by such Market Maker to engage in dealings in accordance with Section 10, below.

(e) Any Market Maker may withdraw its Market Maker status by giving written notice to the Exchange. Such withdrawal shall become effective on the tenth business day following the Exchange's receipt of the notice. A Market Maker who fails to give a ten-day written notice of withdrawal to the Exchange may be subject to formal disciplinary action pursuant to Chapter XXX. Subsequent to withdrawal, the

Member shall not be permitted to re-apply as a Market Maker for a period of six months.

#### *Section 9. Assignments of Market Maker in a Security*

(a) A Market Maker may be assigned a newly authorized security or in a security already admitted to dealings on the BeX by filing an assignment request form with the Exchange. Assignment of the security shall become effective on the first business day following the Exchange's approval of the assignment. In considering the approval of the assignment of the Market Maker in a security, the Exchange may consider:

(1) the financial resources available to the Market Maker;

(2) the Market Maker's experience, expertise and past performance in making markets, including the Market Maker's performance in other securities;

(3) the Market Maker's operational capability;

(4) the maintenance and enhancement of competition among Market Makers in each security in which they are assigned;

(5) the existence of satisfactory arrangements for clearing the Market Maker's transactions;

(6) the character of the market for the security, e.g., price, volatility, and relative liquidity.

(b) A Market Maker's assignment in a security may be terminated by the Exchange if the Market Maker fails to enter quotations in the security within five (5) business days after the Market Maker's assignment in the security becomes effective.

(c) The Exchange may limit the number of Market Makers in a security upon prior written notice to Members.

(d) Market Makers shall be selected by the Exchange. Such selection shall be based on, but is not limited to, the following: experience with making markets in equities; adequacy of capital; willingness to promote the BeX as a marketplace; issuer preference; operational capacity; support personnel; and history of adherence to Exchange rules and securities laws.

(e) Voluntary Termination of Security Registration. A Market Maker may voluntarily terminate its assignment in a security by providing the Exchange with a one-day written notice of such termination. A Market Maker that fails to give advanced written notice of termination to the Exchange may be subject to formal disciplinary action pursuant to Chapter XXX.

(f) The Exchange may suspend or terminate any assignment of a Market Maker in a security or securities under this Section whenever, in the

Exchange's judgment, the interests of a fair and orderly market are best served by such action.

(g) A Member may seek review of any action taken by the Exchange pursuant to this Rule, including the denial of the application for, or the termination or suspension of, a Market Maker's assignment in a security or securities, in accordance with Chapter XXX.

#### *Section 10. Obligations of Market Makers*

(a) General. Members who are assigned as Market Makers in one or more securities traded on the BeX must engage in a course of dealings for their own account to assist in the maintenance, insofar as reasonably practicable, of fair and orderly markets on the BeX in accordance with this Section. The responsibilities and duties of a Market Maker specifically include, but are not limited to, the following:

(1) Maintain continuous, two-sided quotes in those securities in which the Market Maker is assigned to trade;

(2) Maintain adequate minimum capital in accordance with Rule 15(c)3-1 promulgated under the Securities Exchange Act of 1934;

(3) Remain in good standing with the Exchange;

(4) Inform the Exchange of any material change in financial or operational condition or in personnel; and

(5) Clear and settle transactions through the facilities of a registered clearing agency. This requirement may be satisfied by direct participation, use of direct clearing services, or by entry into a correspondent clearing arrangement with another Member that clears trades through such agency.

(b) A Market Maker must satisfy the responsibilities and duties as set forth in paragraph (a) of this Section during the Primary Trading Session on all days in which the Exchange is open for business.

(c) If the Exchange finds any substantial or continued failure by a Market Maker to engage in a course of dealings as specified in paragraph (a) of this Rule, such Market Maker will be subject to disciplinary action or suspension or revocation of the assignment by the Exchange in one or more of the securities in which the Market Maker is assigned. Nothing in this Section will limit any other power of the Board of Directors under the Bylaws, Rules, or procedures of the Exchange with respect to the Market Maker's Membership status or in respect of any violation by a Market Maker of the provisions of this Rule. In accordance with Chapter XXX, a

Member may seek review of actions taken by the Exchange pursuant to this Section.

(d) *Temporary Withdrawal.* A Market Maker may apply to the Exchange to withdraw temporarily from its Market Maker status in the securities in which it is assigned. The Market Maker must base its request on demonstrated legal or regulatory requirements that necessitate its temporary withdrawal, or provide the Exchange an opinion of counsel certifying that such legal or regulatory basis exists. The Exchange will act promptly on such request and, if the request is granted, the Exchange may temporarily reassign the securities to another Market Maker.

(e) Market Makers will be required to maintain minimum performance standards the levels of which may be determined from time to time by the Exchange. Such levels will vary depending on the price, liquidity, and volatility of the security in which the Market Maker is assigned. The performance measurements will include (i) percent of time at the National Best Bid or National Best Offer; (ii) percent of executions better than the National Best Bid or National Best Offer; (iii) average displayed size; (iv) average quoted spread; and (v) in the event the security is a derivative security, the ability of the Market Maker to transact in underlying markets.

#### Section 11. Limitations on Dealings

(a) *General.* A Market Maker on the Exchange may engage in Other Business Activities, or it may be affiliated with a broker-dealer that engages in Other Business Activities, only if there is an Information Barrier (also commonly referred to as "Chinese Wall") between the market making activities and the Other Business Activities. "Other Business Activities" mean:

(1) conducting an investment banking or public securities business; or

(2) making markets in the options overlying the security in which it makes markets.

(b) *Information Barrier.* For the purposes of this rule, an Information Barrier is an organizational structure in which:

(1) The market making functions are conducted in a physical location separate from the locations in which the Other Business Activities are conducted, in a manner that effectively impedes the free flow of communications between persons engaged in the market making functions and persons conducting the Other Business Activities. However, upon request and not on his/her own initiative, a person engaged in the market making functions may furnish to

persons at the same firm or an affiliated firm ("affiliated persons"), the same sort of market information that the person engaged in the market making function would make available in the normal course of its market making activity to any other person. The person engaged in the market making function must provide such information to affiliated persons in the same manner that he/she would make such information available to a non-affiliated person.

(2) There are procedures implemented to prevent the use of material non-public corporate or market information in the possession of persons on one side of the barrier from influencing the conduct of persons on the other side of the barrier.

These procedures, at a minimum, must provide that:

(A) the person performing the function of a Market Maker does not take advantage of knowledge of pending transactions, order flow information, corporate information or recommendations arising from the Other Business Activities; and

(B) all information pertaining to the Market Maker's positions and trading activities is kept confidential and not made available to persons on the other side of the Information Barrier.

(3) Persons on one side of the barrier may not exercise influence or control over persons on the other side of the barrier, provided that:

(A) the market making function and the Other Business Activities may be under common management as long as any general management oversight does not conflict with or compromise the Market Maker's responsibilities under the Rules of the Exchange.

(c) *Documenting and Reporting of Information Barrier Procedures.* A Member implementing an Information Barrier pursuant to this Section shall submit to the Exchange a written statement setting forth:

(1) The manner in which it intends to satisfy the conditions in paragraph (b) of this Section, and the compliance and audit procedures it proposes to implement to ensure that the Information Barrier is maintained;

(2) The names and titles of the person or persons responsible for maintenance and surveillance of the procedures;

(3) A commitment to provide the Exchange with such information and reports as the Exchange may request relating to its transactions;

(4) A commitment to take appropriate remedial action against any person violating this Section or the Member's internal compliance and audit procedures adopted pursuant to subparagraph (c)(1) of this Section, and

that it recognizes that the Exchange may take appropriate remedial action, including (without limitation) reallocation of securities in which it serves as a Market Maker, in the event of such a violation;

(5) Whether the Member or an affiliate intends to clear its proprietary trades and, if so, the procedures established to ensure that information with respect to such clearing activities will not be used to compromise the Member's Information Barrier, which procedures, at a minimum, must be the same as those used by the Member or the affiliate to clear for unaffiliated third parties; and

(6) That it recognizes that any trading by a person while in possession of material, non-public information received as a result of the breach of the internal controls required under this Rule may be a violation of Rules 10b-5 and 14e-3 under the Exchange Act or one or more other provisions of the Exchange Act, the rules thereunder or the Rules of the Exchange, and that the Exchange intends to review carefully any such trading of which it becomes aware to determine whether a violation has occurred.

(d) *Approval of Information Barrier Procedures.* The written statement required by paragraph (c) of this Section must detail the internal controls that the Member will implement to satisfy each of the conditions stated in that Section, and the compliance and audit procedures proposed to implement and ensure that the controls are maintained. If the Exchange determines that the organizational structure and the compliance and audit procedures proposed by the Member are acceptable under this Section, the Exchange shall so inform the Member, in writing. Absent the Exchange finding a Member's Information Barrier procedures acceptable, a Market Maker may not conduct Other Business Activities.

(e) *Clearing Arrangements.* Subparagraph (c)(5) permits a Member or an affiliate of the Member to clear the Member's Market Maker transactions if it establishes procedures to ensure that information with respect to such clearing activities will not be used to compromise the Information Barrier. In this regard:

(1) The procedures must provide that any information pertaining to Market Maker securities positions and trading activities, and information derived from any clearing and margin financing arrangements, may be made available only to those employees (other than employees actually performing clearing and margin functions) specifically

authorized under this Rule to have access to such information or to other employees in senior management positions who are involved in exercising general managerial oversight with respect to the market making activity.

(2) Any margin financing arrangements must be sufficiently flexible so as not to limit the ability of any Market Maker to meet market making or other obligations under the Exchange's Rules.

## Chapter XXXVIII—Regulation NMS

### Section 1. Definitions

(a) "Automated Quotation" means a quotation displayed by a trading center that:

(i) Permits an incoming order to be marked as immediate-or-cancel;

(ii) Immediately and automatically executes an order marked as immediate-or-cancel against the displayed quotation up to its full size;

(iii) Immediately and automatically cancels any unexecuted portion of an order marked as immediate-or-cancel without routing the order elsewhere;

(iv) Immediately and automatically transmits a response to the sender of an order marked as immediate-or-cancel indicating the action taken with respect to such order; and

(v) Immediately and automatically displays information that updates the displayed quotation to reflect any change to its material terms.

(b) "Manual Quotation" means any quotation other than an automated quotation.

(c) "Protected Bid" or "Protected Offer" means a quotation in an NMS stock that:

(i) Is displayed by an automated trading center;

(ii) Is disseminated pursuant to an effective national market system plan; and

(iii) Is an automated quotation that is the best bid or best offer of a national securities exchange, the best bid or best offer of The Nasdaq Stock Market Inc., or the best bid or best offer of a national securities association other than the best bid or best offer of The Nasdaq Stock Market, Inc.

(d) "Protected Quotation" means a Protected Bid or a Protected Offer.

(e) "Regular Way" means bids, offers, and transactions that embody the standard terms and conditions of a market.

(f) "Trading Center" means a national securities exchange or national securities association that operates an SRO trading facility, an alternative trading system, an exchange market maker, an OTC market maker, or any

other broker or dealer that executes orders internally by trading as principal or crossing orders as agent.

### Section 2. Locking or Crossing Quotations in NMS Stocks.

(a) Definitions. For purposes of this Rule, the following definitions shall apply:

(i) The terms automated quotation, effective national market system plan, intermarket sweep order, manual quotation, NMS stock, protected quotation, regular trading hours, and trading center shall have the meanings set forth in SEC Rule 600(b) of Regulation NMS under the Securities Exchange Act of 1934.

(ii) The term crossing quotation shall mean the display of a bid for an NMS stock during regular trading hours at a price that is higher than the price of an offer for such NMS stock previously disseminated pursuant to an effective national market system plan, or the display of an offer for an NMS stock during regular trading hours at a price that is lower than the price of a bid for such NMS stock previously disseminated pursuant to an effective national market system plan.

(iii) The term locking quotation shall mean the display of a bid for an NMS stock during regular trading hours at a price that equals the price of an offer for such NMS stock previously disseminated pursuant to an effective national market system plan, or the display of an offer for an NMS stock during regular trading hours at a price that equals the price of a bid for such NMS stock previously disseminated pursuant to an effective national market system plan.

(b) Prohibition. Except for quotations that fall within the provisions of paragraph (d) of this Rule, members of the Exchange shall reasonably avoid displaying, and shall not engage in a pattern or practice of displaying, any quotations that lock or cross a protected quotation, and any manual quotations that lock or cross a quotation previously disseminated pursuant to an effective national market system plan.

(c) Manual quotations. If a member of the Exchange displays a manual quotation that locks or crosses a quotation previously disseminated pursuant to an effective national market system plan, such member of the Exchange shall promptly either withdraw the manual quotation or route an intermarket sweep order to execute against the full displayed size of the locked or crossed quotation.

(d) Exceptions.

(i) The locking or crossing quotation was displayed at a time when the

trading center displaying the locked or crossed quotation was experiencing a failure, material delay, or malfunction of its systems or equipment.

(ii) The locking or crossing quotation was displayed at a time when a protected bid was higher than a protected offer in the NMS stock.

(iii) The locking or crossing quotation was an automated quotation, and the member of the Exchange displaying such automated quotation simultaneously routed an intermarket sweep order to execute against the full displayed size of any locked or crossed protected quotation.

(iv) The locking or crossing quotation was a manual quotation that locked or crossed another manual quotation, and the member of the Exchange displaying the locking or crossing manual quotation simultaneously routed an intermarket sweep order to execute against the full displayed size of the locked or crossed manual quotation.

### Section 3. Order Routing

(a) Eligible Orders are any orders that are designated by the customer to execute or route. IOC, AIOC, all ISO order types and FOK orders shall not be designated to execute or route.

(b) If any Eligible Order requiring routing to another Trading Center has not been executed in its entirety and the terms of the order require that it be routed to another Trading Center for execution it shall be routed as follows:

(i) Limit Orders shall be routed either in their entirety or as component orders to an away Trading Center(s) as limit orders. Limit Orders will be routed to the Trading Center(s) publishing the best Protected Bid or Protected Offer and will execute against the best Protected Bid or Protected Offer superior or equal to the limit price for the full number of available shares at the away Trading Center(s). The remaining portion of the order, if any, shall be ranked and displayed on the BSE book in accordance with the terms of such order. Market Orders shall be routed in their entirety or as component orders to an away Trading Center(s) as IOC Market Orders. If the Market Order routed to an away Trading Center is not executed in its entirety at the away Trading Center, the BSE would attempt to match the residual or declined Market Order against then available trading interest on the BSE book. Any remaining unmatched trading interest would then be handled in the manner described in Chapter XXXVIII, Section 3 of these proposed rules.

(ii) If the BSE system cannot execute or book an Eligible Order it will route the Eligible Order to another Trading

Center on behalf of the Member who submitted the Eligible Order if that Member is a member or subscriber of the away Trading Center, or in the case where the Member is not a member or subscriber of the away Trading Center the order will be routed on behalf of that Member through a third-party broker dealer, or "give up," that is a member or subscriber of the away Trading Center and, if not executed in its entirety at the away Trading Center, would be handled in the manner described in subsection (b)(i), above.

**Commentary:**

As described above, the Exchange will route orders to other trading centers under certain circumstances ("Routing Services"). The Exchange will provide its Routing Services pursuant to the terms of three separate agreements: (1) An agreement between the Exchange and each Member on whose behalf orders will be routed ("Member-Exchange Agreement"); (2) an agreement between the Exchange and each third-party broker-dealer that will serve as a "give-up" on an away Trading Center when the Member on whose behalf an order is routed is not also a member or subscriber of the away Trading Center ("Give-Up Agreement"); and (3) an agreement between the Exchange and a third-party service provider ("Technology Provider") pursuant to which the Exchange licenses the routing technology used by the Exchange for its Routing Services ("Exchange-Technology Provider Agreement").

.01 (a) The Exchange will provide its Routing Services in compliance with these rules and with the provisions of the Act and the rules thereunder, including, but not limited to, the requirements in Section 6(b)(4) and (5) of the Act that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

(b) As provider of the Routing Services, the Exchange will license the necessary routing technology for use within its own systems and accordingly will control the logic that determines when, how, and where orders are routed away to other Trading Centers.

(c) The Exchange will establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange (including its facilities) and the

Technology Provider, and, to the extent the Technology Provider reasonably receives confidential and proprietary information, that adequately restrict the use of such information by the Technology Provider to legitimate business purposes necessary for the licensing of routing technology.

(d) The Exchange-Technology Provider Agreement will include terms and conditions that enable the Exchange to comply with this Commentary .01.

\* \* \* \* \*

(iii) The order that is routed away shall remain outside the BSE for a prescribed period of time and may be executed in whole or in part subject to the applicable trading rules of the relevant Trading Center. While an order remains outside the Exchange, it shall have no time standing, relative to other orders received from BSE Members at the same price which may be executed against orders in the BSE book. Requests from Members to cancel their orders while the order is routed away to another Trading Center and remains outside the Exchange shall be processed, subject to the applicable trading rules of the relevant Trading Center.

(iv) Where an order or portion of an order is routed away and is not executed either in whole or in part at the other Trading Center (i.e., all attempts at the fill are declined or timed out), the order shall be ranked, displayed and eligible for execution on the BSE book in accordance with the terms of such order.

**Section 4. Order Protection Requirements**

(a) An order is not eligible for execution on the BSE if its execution is at a price that is lower than a Protected Bid or higher than a Protected Offer ("Trade-Through"), or if its execution would be improper under SEC Rule 611 of Regulation NMS (together an "improper trade-through"). If the execution of an order on the Exchange would cause an improper trade-through, that order shall be routed to another appropriate market or, if not designated to route, automatically cancelled.

(b) Exceptions. Purchases and sales of NMS stocks will be excepted from Section 4, paragraph (a) above, and an appropriate modifier approved by the operating committee of the relevant national market system plan for an NMS stock will be attached to the trade before it is publicly reported, in the following circumstances that are exceptions under Rule 611 of Regulation NMS:

(i) Crossed markets. If a trade is executed on the BSE while the National

Best Bid or National Best Offer is crossed;

(ii) Other exceptions.

(1) a non-regular way cross, (2) a single-price opening, reopening or closing trade;

(3) an inbound ISO; or

(4) a benchmark order is executed at the BSE.

(c) In any transaction for or with a customer, a Member and persons associated with a Member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. In all customer transactions, a Member and persons associated with a Member shall comply with all applicable best execution requirements.

(d) Trade-through policies and procedures. In determining whether a trade on the BSE would create an improper trade-through, the BSE will adhere to the terms of the ITS Plan (so long as it is in effect and is applicable to the BSE) and the applicable provisions of Reg NMS (when it takes effect), as well as to the following policies and procedures to the extent the policies and procedures are consistent with the terms of the ITS Plan and Reg NMS:

(i) Clock synchronization and timing of the determination of improper trade-throughs. The BSE's systems shall routinely, throughout the trading day, use processes that capture the time reflected on the atomic clock operated by the National Institute of Standards and Technology and shall automatically make adjustments to the time recorded in the BSE to ensure that the period between the two times will not exceed 500 milliseconds. The BSE shall determine whether a trade would create an improper trade-through based on the most recent National Best Bid and National Best Offer that has been received and processed by the BSE's systems.

(ii) Manual quotations of other markets. The BSE shall disregard another Trading Center's bid or offer if it is identified by the other Trading Center as a manual quotation.

(iii) Self-help exception. The BSE will apply the self-help exception to SEC Rule 611, and the BSE will disregard a Trading Center's bid and offer, if:

(A) The other Trading Center has publicly announced that it is not disseminating automated quotations;

(B) The other Trading Center has repeatedly failed to respond within one second to an incoming AIOC or ISO

order (after adjusting for order transmission time);

(C) The BSE will notify the other Trading Center immediately after having made use of the self-help exception by using an appropriate mechanism for communicating with other Trading Centers. The BSE will continue to apply the self-help exception until the other Trading Center has provided reasonable assurance to the BSE or, more generally, to the public that the problems have been corrected.

(e) The BSE is designed, under the rules set out in this Chapter, to display bids and offers that qualify as automated quotations under the definition set out in SEC Rule 600(b)(3). The BSE shall use the following procedures for determining whether the quotes should be identified as "manual":

(i) *Periodic testing.* The Market Operations Center ("MOC") will have a real time monitoring tool, which will check the elapsed time between receipt of every AIOC order (any order type) and the corresponding response to each AIOC order by the trading system. A predetermined threshold will be set to generate an alert for any instances where the elapsed time between order receipt and response exceeds the preset limit.

(ii) *Adding the "manual" identifier.* Immediately upon receiving an alert from the processes described above in subparagraph (e)(i) that the Exchange's trading system has not accepted and properly handled two or more AIOC orders in a symbol sent as sequential messages the MOC shall append a "manual" identifier to the bids and offers it makes publicly available in that symbol.

(iii) *Returning to automated quotations.* Once the Exchange has made any required systems changes, or has otherwise determined that its quotations satisfy the requirements of SEC Rule 600(b)(3), and has conducted the applicable test(s) set out above to confirm that the Exchange's quotes qualify as "automated quotations," the Exchange shall remove the "manual" identifier from the bids and offers that are made publicly available. The Exchange also shall notify other Trading Centers that its quotations are automated by announcing that fact over the squawk box or other similar functionality available for communications with other Trading Centers.

## 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 Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

In the BeX Facility Filing, the BSE proposed rules to implement the first phase of a new electronic trading facility, called BeX. BeX, which was developed by and is owned and operated by BSX Group, LLC ("BSX"), is an electronic securities communications and trading facility intended for the use of BSE Members, including Electronic Access Members, and their customers.<sup>7</sup> In this rule filing, the Exchange proposes to implement the second phase of the BeX as a fully-automated electronic book for the display and execution of orders in securities listed on any Exchange through the introduction of new rules as well as by amending certain existing rules ("BeX Phase II"). All such issues would not be assigned to a specialist. The new rules will be located in Chapter XXXVII of the Exchange's Rules of the Board of Governors ("BSE Rules"). The BSE also proposes to implement rules to satisfy the requirements of Regulation NMS. These rules will be located in Chapter XXXVIII of the BSE Rules.

The Exchange previously proposed to institute rules governing BeX as a new fully-automated electronic book that would display and match eligible orders in these securities, without the participation of a specialist.<sup>8</sup> As of January 1, 2007, there will no longer be any specialist participation in any transactions on the BSE or otherwise. For competitive reasons, the Exchange considered that proposal to be vitally important to its ability to attract and

retain order flow to the BSE and continues in that belief.<sup>9</sup>

Prior to implementation of the first phase of the BeX, BSE Specialists would quote and trade approximately 300 securities. The BSE Floor Broker community would routinely receive baskets of securities that contained orders and cross trades in securities which were not quoted by BSE Specialists. As such, the orders and cross trades for securities not traded on the BSE would have to be routed to other trading centers ("Trading Centers") for execution. Thus, the Exchange was not able to retain order flow that had been directed to the BSE. Moreover, BSE Floor Brokers were hampered in their ability to attract more sources of order flow to the Exchange, because a percentage of the order flow they do attract was eventually routed to other Trading Centers for execution. The other Trading Centers include those that have the capability to post and execute orders in securities that are not continuously quoted or traded by any Member in a market making capacity, including other exchanges that have rules governing the same type of electronic book functionality that the BSE is now seeking to employ.<sup>10</sup> BeX allows Exchange Members, whether or not they are on the Exchange's floor, to enter orders into the BeX for possible execution.

Additionally, in connection with satisfying the requirements of Regulation NMS, the Exchange proposes to offer several execution enhancements, such as eight additional order types, a rule aimed at the prevention of locked or crossed markets, electronic order routing, and an order protection rule as it transitions to a fully electronic trading venue with its proposed BeX facility and in accordance with the implementation of Regulation NMS. Under the BeX facility, the BSE expects that the current trading rules of the BSE will remain largely intact, with the exception of certain rule proposal changes filed with the Commission

<sup>9</sup> The BSE intends to request from the staff of the Commission a limited exemption from paragraph (a)(2)(i)(A) of Rule 10b-10 under the Act on its own behalf and/or on behalf of its Members who execute trades on the BeX. The exemption request will be limited to those trades that BSE Members execute on BeX with other BSE Members when using the anonymous feature of BeX's electronic trading system. The BSE also intends to request assurance that the Commission staff will not recommend enforcement action to the Commission if, in lieu of making and preserving a separate record, BSE Members rely on BSE's retention of the identities of the BSE Members that execute anonymous trades through BeX to satisfy the requirements of Rules 10a-3(a)(1) and 17a-4(a) under the Act.

<sup>10</sup> See, e.g., Chicago Stock Exchange ("Chx") Rules, Article XXA.

<sup>7</sup> See BeX Governance Filing, note 4, *supra*.

<sup>8</sup> See BeX Facility Filing, note 5, *supra*.

regarding the BeX facility and the rule changes contained herein related to the BeX facility and required under Regulation NMS. The additional order types, rule aimed at prevention of locked and crossed markets, electronic order routing, and order protection rule proposed herein would be options available to BSE members in addition to that which is currently available under the Exchange's existing rule set.

Eligible securities and eligible orders. Under the proposed rules submitted in connection with the first phase of the BeX,<sup>11</sup> all securities eligible for trading on the Exchange that are not assigned to a specialist would be traded in the BeX. Orders sent to the BeX would be required to be specifically designated for handling in the BeX. The BeX accepts only round-lot market and limit orders.

Orders eligible for execution in the BeX may be designated as one of the following existing BSE order types: "at the close," "at the opening or at the opening only," "day," "do not increase (DNI)," "do not reduce (DNR)," "fill or kill," "good 'till cancel," "immediate or cancel," "limit, limited or limited price," "market," "stop limit," or "stop," "cross," "cross with size," "good 'till date (GTD)," "good 'till time (GTT)," "limit or close," or "mid-point cross." In addition to the existing order types set forth above, orders may also be designated as one of the following new order types: "reserve order," "minimum quantity order," "preferred price cross," "automatic immediate or cancel ("AIOC"), "best price intermarket sweep" ("BPISO"), "ISO cross orders," "price-penetrating orders" and "cancel on corporate action orders." It should be noted that AIOC, BPISO, ISO cross and price-penetrating orders are being proposed in connection with the proposed rules related to Regulation NMS but will be located in the same chapter as the new order types being proposed in connection with BeX Phase II. Descriptions of the proposed order types are as follows:

**"Reserve Order":** A Limit Order with a portion of the size displayed and with a reserve portion of the size that is not displayed. The displayed portion of Reserve Orders (not the reserve portion) shall be ranked at the specified limit price and the time of order entry. If the displayed portion of the Reserve Order is decremented such that fewer than 100 shares are displayed, the displayed portion of the Reserve Order shall be replenished for: (a) The displayed amount; or (b) the entire reserve amount, if the remaining reserve

amount is smaller than the displayed amount. Upon replenishment the reserve portion shall be submitted and ranked at the specified limit price and time of replenishment. A Reserve Order cannot be an IOC Order or Market Order.

**"Minimum Quantity":** A Minimum Quantity Order is an Order subject to the provisions of Chapter XXXVII, Section 6, that, upon entry, must be executed at least at its minimum quantity or it will be cancelled. If executed in part, the remaining quantity remains in the book and follows the execution rule of the order price type. A Stop Limit Order can be a minimum quantity and execution possibility will be checked at the election of the Order.

**"Preferred Price Cross":** A Cross Order with a preferred limit price and an optional preferred tick, both set by the Member.<sup>12</sup> A preferred limit price is the limit price the cross order will be executed at if it is equal to or better than the National Best Bid or Offer ("Preferred Limit Price"). The optional preferred tick is the amount of ticks beyond the preferred limit price at which the two-sided cross order may be executed ("Optional Preferred Tick"). The Preferred Price Cross order cannot be executed at a price that is more than the preferred limit price plus the amount of optional preferred ticks or less than the preferred limit price minus the amount of optional preferred ticks. If the Preferred Price Cross cannot be executed at the Preferred Limit Price, the execution price of the Cross will be determined by the Trading System to be the closest price to the Preferred Limit Price, respecting the Optional Preferred Tick and the National Best Bid or Offer.

**AIOC Order:** An automatic immediate or cancel order is an order received on BeX that will execute immediately and automatically, either in whole or in part, at or better than its limit price, with any unexecuted balance of the order to be immediately cancelled. The unexecuted portion of the order will not be routed to another Trading Center.

**Best Price ISO:** A best price intermarket sweep order is an order marked as required by Rule 600(b)(30) under the Act that is to be executed against any orders at the Exchange's Best Bid or Best Offer (including any undisplayed orders at that price) as soon

as the order is received by the BSE, with any unexecuted balance of the order to be immediately cancelled. The BSE, in executing the Best Price ISO, shall not take any of the actions described in Chapter XXXVIII, Section 4 to prevent an improper trade through.

**Price-Penetrating ISO:** An order marked as required by Rule 600(b)(30) under the Act that is to be executed at or better than its limit price as soon as the order is received by the BSE, with any unexecuted balance of the order to be immediately cancelled. Orders marked as price-penetrating ISO shall be executed against any eligible orders at the BSE (including any reserve size or other undisplayed orders, through multiple price points). The BSE, in executing these orders, shall not take any of the actions described in Chapter XXXVIII, Section 4 to prevent an improper trade-through.

**ISO Cross:** A two sided order that, upon receipt, will be executed without any action on the part of the Exchange to prevent an improper trade through. The Member submitting an ISO Cross is responsible for checking all protected quotes and must send one or more ISO orders to other Trading Centers displaying a price better than the cross price.

**Cancel on Corporate Action:** In the event of a dividend, distribution or stock split ("Corporate Action"), the order in the limit book will be cancelled.

**Compliance with Intermarket Trading System ("ITS") Plan.** As set forth in the BeX Facility Filing, to ensure compliance with the ITS Plan (as long as it remains in effect), otherwise eligible orders would be cancelled or routed away in certain circumstances. Specifically, if an order in an ITS eligible security crosses or locks the National Best Bid or National Best Offer at the time that it is received, the order would be immediately cancelled to ensure compliance with the ITS Plan's rules relating to locked markets.<sup>13</sup> Marketable orders that would trade-through the National Best Bid or National Best Offer would either be cancelled or be routed to the market(s) showing the National Best Bid or National Best Offer at the order-entering firm's instructions.<sup>14</sup>

<sup>12</sup> The Exchange represents that a Preferred Price Cross Order must satisfy the conditions of either a Cross Order or a Cross with Size Order. Telephone call between Brian D. Donnelly, Assistant Vice President of Regulation & Compliance, and Dan Hamm, Vice President of Trading Systems, BSE, and Nancy Sanow, Assistant Director, and Ira Brandriss, Special Counsel, Division of Market Regulation, Commission on August 4, 2006.

<sup>13</sup> Similarly, if an order in a listed security locks or crosses the Best Bid or Best Offer in BeX at the time it is received, but not the National Best Bid or National Best Offer, the order would be executed according to BeX's matching algorithm, and any remaining portion would be immediately cancelled, if it would lock or cross the National Best Bid or National Best Offer.

<sup>14</sup> See BeX Facility Filing, proposed BSE Rule, Chapter XXXVII, Section 3, Paragraph (j)(i) and (iii).

<sup>11</sup> See BeX Facility Filing, note 5, *supra*.



### Ranking and Display of Orders

Except as otherwise permitted by Section 3, paragraphs (v)–(vi) of the BSE Rules, all orders at all price levels on the BeX shall be displayed to all Members on an anonymous basis and transactions executed on the BeX will be processed anonymously.<sup>15</sup> The transaction reports will indicate the details of the transaction, but will not reveal contra party identities. No Member having the right to trade through the facilities of BeX and who has been a party to or has knowledge of an execution shall be under obligation to divulge the name of the buying or selling firm in any transaction. Except as otherwise permitted by the supplementary material in Section 3, no Member shall transmit through the facilities of BeX any information regarding a bid, offer, other indication of an order, or the Member's identity, to another Member until permission to disclose and transmit such bid, offer, other indication of an order, or the Member's identity has been obtained from the originating Member or the originating Member affirmatively elects to disclose its identity.

The BeX will reveal the identity of a Member in the following circumstances: (1) For regulatory purposes or to comply with an order of a court or arbitrator; (2) when the National Securities Clearing Corporation ("NSCC") ceases to act for a Member or the Member's clearing firm, and NSCC determines not to guarantee the settlement of the Member's trades; or (3) on risk management reports provided to the contra party of the Member or Member's clearing firm each day by 4 p.m. (E.S.T.) which disclose trading activity on the aggregate dollar value basis.

In order to satisfy Members' record keeping obligations under Rules 17a–3(a)(1) and 17a–4(a) under the Act, BSE shall retain for the period specified in Rule 17a–4(a) the identity of each Member that executes an anonymous transaction described in paragraph (i)(iii) of this rule. The information shall be retained by the BeX in its original form or a form approved under Rule 17a–6. Members shall retain the obligation to comply with Rules 17a–3(a)(1) and 17a–4(a) under the Act whenever they possess the identity of their contra party.

### Market Makers

BSE Members may apply for Market Maker status. An applicant shall file an application for Market Maker status on such form as the Exchange may

prescribe. Applications shall be reviewed by the Exchange, which shall consider such factors including, but not limited to capital operations, personnel, technical resources, and disciplinary history. No Member shall act as a Market Maker in any security unless such Member has been approved as a Market Maker in a security by the Exchange pursuant to the BSE Rules and the Exchange has not suspended or canceled such approval. Approved Market Makers are designated as dealers on the Exchange for all purposes under the Act the rules and regulations thereunder.

An applicant's Market Maker status shall become effective upon receipt by the Member of notice of an approval by the Exchange. In the event that an application is disapproved by the Exchange, the applicant shall have an opportunity to be heard upon the specific grounds for the denial, in accordance with the provisions of Chapter XXX of the BSE Rules.

Market Maker status may be suspended or terminated by the Exchange upon a determination of any substantial or continued failure by such Market Maker to engage in dealings in accordance with the BSE Rules. Likewise, any Market Maker may withdraw its Market Maker status by giving written notice to the Exchange. Such withdrawal shall become effective on the tenth business day following the Exchange's receipt of the notice. A Market Maker who fails to give a ten-day written notice of withdrawal to the Exchange may be subject to formal disciplinary action pursuant to Chapter XXX. Subsequent to withdrawal, the Member shall not be permitted to re-apply as a Market Maker for a period of six months.

A Market Maker may be assigned a newly authorized security or a security already admitted to dealings on the BeX by filing an assignment request form with the Exchange. Assignment of the security shall become effective on the first business day following the Exchange's approval of the assignment. In considering the approval of the assignment of the Market Maker in a security, the Exchange may consider: (1) The financial resources available to the Market Maker; (2) the Market Maker's experience, expertise and past performance in making markets, including the Market Maker's performance in other securities; (3) the Market Maker's operational capability; (4) the maintenance and enhancement of competition among Market Makers in each security in which they are assigned; (5) the existence of satisfactory arrangements for clearing the Market

Maker's transactions; (6) the character of the market for the security, *e.g.* price, volatility, and relative liquidity. A Market Maker's assignment in a security may be terminated by the Exchange if the Market Maker fails to enter quotations in the security within five (5) business days after the Market Maker's assignment in the security becomes effective. Moreover, the Exchange may limit the number of Market Makers in a security upon prior written notice to Members.

Market Makers shall be selected by the Exchange based on, but is not limited to, the following: Experience with making markets in equities; adequacy of capital; willingness to promote the BeX as a marketplace; issuer preference; operational capacity; support personnel; and history of adherence to Exchange rules and securities laws.

A Market Maker may voluntarily terminate its assignment in a security by providing the Exchange with a one-day written notice of such termination. A Market Maker that fails to give advanced written notice of termination to the Exchange may be subject to formal disciplinary action pursuant to Chapter XXX. Furthermore, the Exchange may suspend or terminate any assignment of a Market Maker in a security or securities under Chapter XXXVII, Section 9 whenever, in the Exchange's judgment, the interests of a fair and orderly market are best served by such action. A Member may seek review of any action taken by the Exchange pursuant to this Rule, including the denial of the application for, or the termination or suspension of, a Market Maker's assignment in a security or securities, in accordance with Chapter XXX.

Members who are assigned as Market Makers in one or more securities traded on the BeX must engage in a course of dealings for their own account to assist in the maintenance, insofar as reasonably practicable, of fair and orderly markets on the BeX in accordance with this Section. The responsibilities and duties of a Market Maker specifically include, but are not limited to, the following: (1) Maintain continuous, two-sided quotes in those securities in which the Market Maker is assigned to trade; (2) maintain adequate minimum capital in accordance with Rule 15(c)3–1 promulgated under Act; (3) remain in good standing with the Exchange; (4) inform the Exchange of any material change in financial or operational condition or in personnel; (5) clear and settle transactions through the facilities of a registered clearing agency. This requirement may be

<sup>15</sup> See note 9, *supra*.

satisfied by direct participation, use of direct clearing services, or by entry into a correspondent clearing arrangement with another Member that clears trades through such agency. A Market Maker must satisfy the responsibilities and duties during the Primary Trading Session on all days in which the Exchange is open for business.

If the Exchange finds any substantial or continued failure by a Market Maker to engage in a course of dealings as specified in the applicable BSE Rules, such Market Maker will be subject to disciplinary action or suspension or revocation of the assignment by the Exchange in one or more of the securities in which the Market Maker is assigned. Nothing in this Section will limit any other power of the Board of Directors under the Bylaws, Rules, or procedures of the Exchange with respect to the Market Maker's Membership status or in respect of any violation by a Market Maker of the provisions of this Rule. In accordance with Chapter XXX, a Member may seek review of actions taken by the Exchange pursuant to this Section.

A Market Maker may apply to the Exchange to withdraw temporarily from its Market Maker status in the securities in which it is assigned. The Market Maker must base its request on demonstrated legal or regulatory requirements that necessitate its temporary withdrawal, or provide the Exchange an opinion of counsel certifying that such legal or regulatory basis exists. The Exchange will act promptly on such request and, if the request is granted, the Exchange may temporarily reassign the securities to another Market Maker.

Market Makers will be required to maintain minimum performance standards the levels of which may be determined from time to time by the Exchange. Such levels will vary depending on the price, liquidity, and volatility of the security in which the Market Maker is assigned. The performance measurements will include (i) percent of time at the National Best Bid or National Best Offer; (ii) percent of executions better than the National Best Bid or National Best Offer; (iii) average displayed size; (iv) average quoted spread; and (v) in the event the security is a derivative security, the ability of the Market Maker to transact in underlying markets.

A Market Maker on the Exchange may engage in Other Business Activities, or it may be affiliated with a broker-dealer that engages in Other Business Activities, only if there is an Information Barrier (also commonly referred to as "Chinese Wall") between

the market making activities and the Other Business Activities. "Other Business Activities" mean: (1) Conducting an investment banking or public securities business; or (2) making markets in the options overlying the security in which it makes markets.

A Member or an affiliate of the Member may clear the Member's Market Maker transactions if it establishes procedures to ensure that information with respect to such clearing activities will not be used to compromise the Information Barrier. In this regard: (1) The procedures must provide that any information pertaining to Market Maker securities positions and trading activities, and information derived from any clearing and margin financing arrangements, may be made available only to those employees (other than employees actually performing clearing and margin functions) specifically authorized under this Rule to have access to such information or to other employees in senior management positions who are involved in exercising general managerial oversight with respect to the market making activity; and (2) any margin financing arrangements must be sufficiently flexible so as not to limit the ability of any Market Maker to meet market making or other obligations under the Exchange's Rules.

#### **Locked and Crossed**

BSE Members would have an obligation to reasonably avoid displaying, and avoid engaging in a pattern or practice of displaying any quotations that lock or cross a protected quotation, and any manual quotations that lock or cross a quotation previously disseminated pursuant to an effective national market system plan. This rule would be contained in new Chapter XXXVIII, Section 2 of the BSE Rules.

For purposes of this rule a "crossing quotation" would mean the display of a bid for a NMS stock during regular trading hours at a price that is higher than the price of an offer for such NMS stock previously disseminated pursuant to an effective national market system plan, or the display of an offer for a NMS stock during regular trading hours at a price that is lower than the price of a bid for such NMS stock previously disseminated pursuant to an effective national market system plan. For purposes of this rule, a "locking quotation" would mean the display of a bid for a NMS stock during regular trading hours at a price that equals the price of an offer for such NMS stock previously disseminated pursuant to an effective national market system plan, or the display of an offer for a NMS stock

during regular trading hours at a price that equals the price of a bid for such NMS stock previously disseminated pursuant to an effective national market system plan.

The rule would provide for four exceptions from the prohibition on locking or crossing protected quotations. First, the rule would except those quotations displayed at a time when the trading customer displaying the locked or crossed quotation was experiencing a failure, material delay or malfunction of its systems or equipment. Second, the rule would also except those quotations displayed at a time when the protected bid was higher than a protected offer in the NMS stock. Third, the rule would except those automated quotations where the BSE member displaying such automated quotation simultaneously routed an intermarket sweep order to execute against the full displayed size of any locked or crossed protected quotation. For example, if there is a reserve size behind the displayed size of the previously displayed protected quotation, its price may not change even after execution of the intermarket sweep order. Fourth, the rule would except those manual quotations that locked or crossed another manual quotation, and the BSE member displaying the locking or crossing manual quotation simultaneously routed an intermarket sweep order to execute against the full displayed size of the locked or crossed manual quotation.

The rule does not specify any procedures for reconciling unintentional locks/crosses when both quotations are automated as trading should continue and market forces will reconcile the lock/cross. Market forces are likely to generate orders that will quickly resolve the lock/cross quotations.

#### **Order Routing**

The BSE is proposing a rule, in accordance with Regulation NMS, that would govern the order routing process. The rules on electronic order routing would be contained in new Chapter XXXVIII, Section 3.

The BSE will only route an Eligible Order when the order has not been executed in its entirety and the terms of the order require routing to another Trading Center for execution. The BSE has determined that Eligible Orders are orders that are designated by the customer to execute or route. IOC, AIOC, all ISO order types and FOK orders shall not be designated to execute or route.

Limit Orders shall be routed either in their entirety or as component orders to an away Trading Center(s). Limit Orders will be routed to the Trading Center(s)

publishing the best Protected Bid or Protected Offer and will execute against the best Protected Bid or Protected Offer superior or equal to the limit price for the full number of available shares at the away Trading Center(s). The remaining portion of the order, if any, shall be ranked and displayed on the BSE book in accordance with the terms of such order. Market Orders shall be routed in their entirety or as component orders to an away Trading Center(s) as IOC Market Orders. If a Market Order routed to an away Trading Center is not executed in its entirety at the away Trading Center, the BSE would attempt to match the residual or declined Market Order against then available trading interest on the BSE book. Any remaining unmatched trading interest would then be handled in the manner described in Chapter XXXVIII, Section 3 of these proposed rules.<sup>16</sup>

Eligible Orders will be routed on behalf of the Member who submitted the Eligible Order if that Member is a member or subscriber of the away Trading Center or, in the case where the Member is not a member or subscriber of the away Trading Center, the order will be routed through a third party broker dealer, or "give up," that is a member or subscriber of the away Trading Center pursuant to the terms of an agreement entered into between the BSE and that third party broker dealer which agreement is described below. The Eligible Order would route to another Trading Center as a limit order priced at the quote published by the Trading Center (an ISO).

As stated above, the Exchange will route orders to other trading centers under certain circumstances ("Routing Services"). The Exchange will provide its Routing Services pursuant to the terms of three separate agreements: (1) An agreement between the Exchange and each Member on whose behalf orders will be routed ("Member-Exchange Agreement"); (2) an agreement between the Exchange and each third-party broker-dealer that will serve as a "give-up" on an away trading center when the Member on whose behalf an order is routed is not also a member or subscriber of the away trading center ("Give-Up Agreement"); and (3) an agreement between the

Exchange and a third-party service provider ("Technology Provider") pursuant to which the Exchange licenses the routing technology used by the Exchange for its Routing Services ("Exchange-Technology Provider Agreement").

The Exchange will provide its Routing Services in compliance with these rules and with the provisions of the Act and the rules thereunder, including, but not limited to, the requirements in Section 6(b)(4) and (5) of the Act that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities, and not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

As provider of the Routing Services, the Exchange will license the necessary routing technology for use within its own systems and accordingly will control the logic that determines when, how, and where orders are routed away to other trading centers.

The Exchange will establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Exchange (including its facilities) and the Technology Provider, and, to the extent the Technology Provider reasonably receives confidential and proprietary information, that adequately restrict the use of such information by the Technology Provider to legitimate business purposes necessary for the licensing of routing technology. The Exchange-Technology Provider Agreement will include terms and conditions that enable the Exchange to comply with all of its applicable Rules.

As stated above, if an Eligible Order has not been executed in its entirety on the BSE, the order would route to another Trading Center as a limit order priced at the quote published by the Trading Center (an ISO). ISOs Orders routed to other Trading Centers would remain outside the BSE for a prescribed time period during which such orders could be executed (in whole or in part) or declined. While an order remains outside the BSE, it would have no time standing relative to others received from BSE Members at the same price that could be executed against interest on the BSE book. Requests from BSE Members to cancel their orders while the ISO is routed away to another Trading Center and remains outside the BSE would be processed subject to applicable trading rules of the relevant away Trading Center. When routing an

order away to another Trading Center, the BSE would utilize such electronic intermarket linkages and order delivery facilities as could be approved by the BSE Board from time to time, subject to such applicable requirements as could be agreed to with the relevant Trading Center, subject to Commission approval or a proposed rule change submitted in accordance with Rule 19b-4 under the Act.

Where an order or portion of an order is routed away and is not executed either in whole or in part at the other Trading Center (*i.e.*, all attempts at the fill are declined or timed out), the order shall be ranked, displayed and eligible for execution on the BSE book in accordance with the terms of such order. In the event that a marketable order routed from the BSE to another Trading Center is not executed in its entirety at the other Trading Center's quote, the BSE would attempt to match the residual or declined market order against then available trading interest on the BSE book. Any remaining unmatched trading interest would then be handled in the manner described in Chapter XXXVIII, Section 3 of these proposed rules.

#### Order Protection Rule

The BSE, in accordance with the requirements of Regulation NMS, is proposing an order protection rule that would be contained in new Chapter XXXVIII, Section 4. The proposed rule would prohibit trades from being executed on the BSE if the execution would result in an improper trade-through, *i.e.*, at a price lower than a Protected Bid or higher than a Protected Offer. If the execution of an order on the Exchange would cause an improper trade-through, that order would be routed to another appropriate market or, if designated as "do not route," automatically cancelled. Members, however, would still be subject to all applicable best execution requirements.

The BSE does provide for several exceptions to the trade-through rule. Some of the exceptions include: a crossed markets exception, a non-regular way cross exception, a single priced opening, reopening or closing trade exception, an inbound ISO exception, a stop order exception and a benchmark order executed at the BSE exception. If a purchase or sale of an NMS stock does qualify for an exception to the order protection rule, an appropriate modifier approved by the operating committee of the relevant national market system plan for an NMS stock will be attached to the trade before it is publicly reported.

<sup>16</sup>The Exchange has advised that it intends to file an amendment to the proposed rule change that sets forth more clearly the handling by BeX of the remainder of an order that has been routed to an away Trading Center. Telephone call between Brian D. Donnelly, Assistant Vice President of Regulation & Compliance, and Dan Hamm, Vice President of Trading Systems, BSE, and Nancy Sanow, Assistant Director, and Ira Brandriss, Special Counsel, Division of Market Regulation, Commission on August 4, 2006.

The BSE would be an automated trading system which displays bids and offers that qualify as automated quotations under the definition set out in Rule 600(b)(3) under the Act, with manual capabilities in the event the automated trading feature is not available.

In order to determine whether a trade would constitute an improper trade-through the BSE's systems would routinely, throughout the trading day, synchronize their time clocks and would immediately make adjustments to the time recorded in the BSE to ensure that the period between the two times would not exceed 500 milliseconds.

If another market is displaying a manual quotation, the BSE would be able to disregard that market's bid or offer. The BSE would also be able to disregard another Trading Center's bid and offer if: the other market has publicly announced that it is not disseminating automated quotations and/or the other market has repeatedly failed to respond within one second to an incoming AIOC or ISO order (after adjusting for order transmission time).

If the BSE bypassed another Trading Center's quote it would immediately notify the Trading Center after having used the "self-help" exception through an appropriate mechanism for communicating with other Trading Centers. The BSE would be able to avail itself of the self-help exception until the other Trading Center has provided reasonable assurance to the BSE or to the public that the problems have been corrected.

If the BSE has not accepted two or more AIOC orders sent as sequential test messages, the BSE will attach a "manual" identifier to its bids and offers it makes publicly available. Additionally, immediately upon receiving an alert from the processes that the Exchange's trading system has taken more than 2 seconds to process any one AIOC order, the MOC shall automatically attach a "manual" identifier to the bids and offers it makes publicly available. If for some reason the MOC is unable to attach a manual identifier, the Exchange shall announce that its quotes are manual through an appropriate mechanism for communicating with other Trading Centers.

Once the BSE has made any required systems changes, or has otherwise determined that its quotations satisfy the requirements of Rule 600(b)(3) under the Act, and has conducted applicable tests set out above to confirm that the Exchange's quotes qualify as "automatic quotations," the Exchange

would remove the "manual" identifier from the bids and offers that are made publicly available. The Exchange would also have to notify other Trading Centers that its quotations are automated by announcing that fact through an appropriate mechanism for communicating with other Trading Centers.

### Conclusion

The Exchange represents that it has designed the BeX to be a fully-automated system that would permit eligible orders in eligible securities to match against one another, without the required participation of a specialist. The Exchange believes that this system functionality would provide all Exchange Members with an efficient way to trade securities that would protect investors and the public interest by automatically handling orders in a fair and reasonable manner. Additionally, the BSE believes that the changes proposed herein are designed to enhance competition in the U.S. equities markets, particularly given the electrification of the marketplace and other fundamental changes that are rapidly taking place. The Exchange submits that the changes proposed herein are, among other things, intended to bring the BSE into compliance with the requirements of Regulation NMS.

### 2. Statutory Basis

The basis for this proposed rule and proposed rule change is that Exchange believes its proposals are consistent with Section 6(b)<sup>17</sup> of the Act and further the objectives of Section 6(b)(5)<sup>18</sup> of the Act in particular, because they are 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.

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

The Exchange 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*

The Exchange has neither solicited nor received comments on the proposed rule change.

<sup>17</sup> 15 U.S.C. 78f(b).

<sup>18</sup> 15 U.S.C. 78f(b)(5).

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

Within 35 days of the date of 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 self-regulatory organization 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 is consistent with the Act. Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-BSE-2006-30 on the subject line.

#### *Paper Comments*

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File No. SR-BSE-2006-30. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at

the principal office of the above-mentioned self-regulatory organization. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the file number in the caption above and should be submitted on or before September 6, 2006.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

**Nancy M. Morris,**  
Secretary.

[FR Doc. E6-13400 Filed 8-15-06; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-54288; File No. SR-NASDAQ-2006-008]

### Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Order Granting Approval of a Proposed Rule Change Requiring Securities be Eligible To Participate in a Direct Registration System

August 8, 2006.

#### I. Introduction

On April 27, 2006, The NASDAQ Stock Market LLC ("Nasdaq") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-NASDAQ-2006-008 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the *Federal Register* on June 7, 2006.<sup>2</sup> Two comment letters were received.<sup>3</sup> For the reasons discussed below, the Commission is granting approval of the proposed rule change.<sup>4</sup>

<sup>19</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. 53913 (May 31, 2006), 71 FR 33024 (June 7, 2006) [File No. SR-NASDAQ-2006-008].

<sup>3</sup> Letters from Noland Cheng, Chairman, SIA Operations Committee, Securities Industry Association (June 27, 2006) and Paul Conn, President, Global Capital Markets, Computershare Limited, and Charlie Rossi, Executive Vice President, Computershare Investor Services (July 28, 2006).

<sup>4</sup> Concurrent with the Commission's approval of Nasdaq's rule change, the Commission is also approving in separate orders similar rule changes proposed by the American Stock Exchange LLC ("Amex") and the New York Stock Exchange LLC ("NYSE"). Securities Exchange Act Release Nos. 54290 (August 8, 2006) [File No. SR-Amex-2006-40] and 54289 (August 8, 2006) [File No. SR-NYSE-2006-29]. The Commission has also published

#### II. Description

The Direct Registration System ("DRS") allows an investor to establish either through the issuer's transfer agent or through the investor's broker-dealer a book-entry position on the books of the issuer and to electronically transfer her position between the transfer agent and the broker-dealer of her choice through a facility currently administered by The Depository Trust Company ("DTC").<sup>5</sup> DRS, therefore, enables an investor to have securities registered in her name without having a securities certificate issued to her and to electronically transfer her securities to her broker-dealer in order to effect a transaction without the risk and delays associated with the use of securities certificates.

Investors holding their securities in DRS retain the rights associated with securities certificates, including such rights as control of ownership and voting rights, without having the responsibility of holding and safeguarding securities certificates. In addition, in corporate actions such as reverse stock splits and mergers, cancellation of old shares and issuance of new shares are handled electronically with no securities certificates to be returned to or received from the transfer agent.

In order to reduce the number of transactions in securities for which settlement is effected by the physical delivery of securities certificates and thereby reduce the risks, costs, and delays associated with the physical delivery of securities certificates, Nasdaq is proposing to add new Section (I) to its Rule 4350 to require that all listed securities be eligible to participate in DRS.<sup>6</sup> While the rule change requires that issuers' securities be eligible for DRS, it does not require issuers to participate in DRS operated by DTC and would not mandate the elimination of physical certificates. As a result, subject to applicable state law and the company's governing documents, an investor could still elect to receive a

notice of a similar rule change proposed by NYSE Arca, Inc. Securities Exchange Act Release No. 54126 (July 11, 2006), 71 FR 40768 (July 18, 2006) [File No. SR-NYSEArca-2006-31].

<sup>5</sup> Currently, the only registered clearing agency operating a DRS is DTC. For a detailed description of DRS and the DRS facilities administered by DTC, see Securities Exchange Act Release Nos. 37931 (November 7, 1996), 61 FR 58600 (November 15, 1996), [File No. SR-DTC-96-15] (order granting approval to establish DRS) and 41862 (September 10, 1999), 64 FR 51162 (September 21, 1999), [File No. SR-DTC-99-16] (order approving implementation of the Profile Modification System).

<sup>6</sup> The exact text of the Nasdaq proposed rule change is set forth in its filing, which can be found at <http://www.complinet.com/nasdaq/display/display.html?rbid=1705&elementid=26>.

certificate if the issuer chose to make certificates available.

Because currently the only DRS operated by a registered clearing agency is the DRS operated by DTC, in order for a security to be eligible to participate in DRS, an issuer will be required to use a transfer agent that meets DTC's DRS transfer agent requirements, including insurance and connectivity requirements. As a result, some transfer agents acting for Nasdaq issuers may have to make changes to comply with these requirements. Certain issuers may also have to make amendments to their governing documents, such as their by-laws, to be eligible to issue securities that are not represented by certificates. To allow sufficient time for any of these changes that need to take place, Nasdaq will implement the proposed rule change January 1, 2008, for the securities of issuers with securities already listed on Nasdaq or another listed marketplace at the time the rule change is approved. Companies listing for the first time should have greater flexibility to adopt any changes required to have their securities DRS eligible, and therefore, the rule change will be applicable to new listings beginning January 1, 2007. The requirement will not apply to non-equity securities that are held in book-entry-only form.

#### III. Comment Letters

The Commission received two comment letters in support of the proposed rule change.<sup>7</sup> The SIA Operations Committee ("SIA"), an industry organization representing broker-dealers, stated that the effect of the proposed rule change will be to reduce significantly the number of transactions in securities for which settlement is effected by the physical delivery of securities certificates thereby reducing costs, risks, and delays associated with physical settlement. The SIA also contended that by increasing the number of DRS-eligible securities, the proposed rule change is an important step in reducing the number of physical certificates, a goal the SIA has long supported in its efforts to promote immobilization and dematerialization.

Computershare, a registered transfer agent, stated that the proposed rule change will help immobilize and eventually dematerialize certificates in the U.S. market, which it believes will result in benefits such as cost savings,

<sup>7</sup> *Supra* note 3. The SIA and Computershare's comment letters were written in support of the three similar proposed rule changes filed by Amex, Nasdaq, and NYSE. *Supra* note 4. The NYSE Arca's proposed rule change was noticed by the Commission subsequent to the date the commenters submitted their comment letters.