

role as agent and principal in executing transactions. In particular, Congress intended to prevent specialists from unduly influencing market trends through their knowledge of market interest from the specialists' books and their handling of discretionary agency orders.<sup>3</sup> Although the Securities and Exchange Commission ("Commission") has interpreted Section 11(b) to mean that all orders, other than market or limit orders, are discretionary and therefore cannot be accepted by a specialist, it has made certain exceptions. For example, the Commission has concluded that it is appropriate to treat percentage orders<sup>4</sup> and stopped orders<sup>5</sup> as equivalent to limit orders because, although these orders permit a specialist to use his or her judgment to some extent, the exchange rules applicable to these orders impose sufficiently stringent guidelines to ensure that a specialist would handle the orders in a manner consistent with his or her market making duties and Exchange Act Section 11(b). Accordingly, the Commission approved exchanges' proposals to permit specialists to accept percentage orders under certain circumstances<sup>6</sup> and to engage in the

practice of "stopping" stock.<sup>7</sup> Specifically, in approving the NYSE's proposal to allow specialists to convert a percentage order on a destabilizing tick and to convert a percentage order into a limit order to enter a quotation that betters the market,<sup>8</sup> the Commission acknowledged that the NYSE's proposal permitted specialists to employ their judgment to a greater extent than the existing percentage order rule.<sup>9</sup> However, the Commission concluded that the requirements imposed on a specialist when converting a percentage order for execution or quotation purposes provided sufficient limits on the

at the price of the electing sale is not executed, the elected portion of the order shall be cancelled and re-entered on the book at the price of subsequent transactions on the NYSE, if the price of the subsequent transactions is at or better than the limit specified in the order; 30265 (January 17, 1992), 57 FR 3228 (January 28, 1992) (approving an Amex proposal to permit a specialist to accept "last sale" and "buy minus-sell plus" percentage orders, permit the conversion of a percentage order into a limit order on a destabilizing tick, and allow conversions that better the market); 24505 (May 22, 1987), 52 FR 20484 (June 1, 1987) ("1987 Order") (permitting a NYSE specialist to convert a percentage order into a limit order on a destabilizing tick and to convert a percentage order into a limit order to enter a quote that betters the market); 20738 (March 8, 1984), 49 FR 9666 (March 14, 1984) (allowing an entering broker to instruct an Amex specialist to convert half of a percentage order rather than the full amount of the percentage order); 19652 (April 5, 1983), 48 FR 15756 (April 12, 1983) (approving an Amex proposal to permit percentage orders to be converted and executed on zero plus ticks (for buy orders) and zero minus ticks (for sell orders) when the order causing the conversion is at least 5,000 shares); and 19466 (January 28, 1983), 48 FR 5627 (February 7, 1983) (amending the Amex's definition of percentage order to differentiate among straight limit, last sale, and buy minus-sell plus percentage orders and adopting procedures for the handling of percentage orders).

<sup>7</sup> The Commission granted permanent approval to the pilot programs of several exchanges that permit specialists to stop stock in minimum variation markets. See Exchange Act Release Nos. 37134 (April 22, 1996), 61 FR 18634 (April 26, 1996) ("BSE 1996 Order"); 36400 (October 20, 1995), 60 FR 54886 (October 26, 1995) ("Amex 1995 Order"); 36401 (October 20, 1995), 60 FR 54893 (October 26, 1995) ("CHX 1995 Order"); and 36399 (October 20, 1995), 60 FR 54900 (October 26, 1995) ("NYSE 1995 Order"). See also Exchange Act Release No. 40728 (November 30, 1998), 63 FR 67972 (December 9, 1998) (approving a Philadelphia Stock Exchange, Inc. ("PHLX") rule setting forth procedures for stopping stock where the spread in the quotation is greater than twice the minimum variation and for stopping orders in minimum variation markets). The rules of several exchanges permit specialists to stop stock when the spread is twice the minimum variation. See Amex Rule 109(c); Boston Stock Exchange ("BSE") Rule Chapter II, Section 38(b); NYSE Rule 116.30; and PHLX Rule 220. In addition, Chicago Board Options Exchange, Inc. market makers may stop options orders. See CBOE Rule 8.17.

<sup>8</sup> A conversion that betters the market narrows the spread, adds depth to a prevailing bid or offer, or establishes a new bid or offer immediately after a transaction has cleared the floor of bids and offers.

<sup>9</sup> See 1987 Order, *supra* note 5.

specialist to ensure that the specialist would implement the conversion provisions in a manner consistent with his or her market making duties and Section 11(b) of the Exchange Act.<sup>10</sup> These requirements are intended to minimize a specialist's discretion and to ensure that the specialist cannot, through his or her use of the conversion process, unduly influence market trends.

In addition, in approving exchanges' rules permitting specialists to stop stock in minimum variation markets, the Commission found it appropriate to treat stopped orders as equivalent to limit orders because a stopped order would be automatically elected at the best bid or offer, or better if obtainable.<sup>11</sup> The Commission noted that although stopped orders permit a specialist to employ his or her judgment to some extent, the requirements imposed on a specialist for granting stops in minimum variation markets provide that the specialist will implement the stopping stock provisions in a manner consistent with his or her market making duties and Section 11(b).<sup>12</sup>

<sup>10</sup> Specifically, the 1987 Order noted that the NYSE's proposal imposed three basic limitations on the conversion of percentage orders on a destabilizing tick: (1) An order may be converted on a destabilizing tick for the purpose of participating in a trade of 10,000 or more shares; (2) the execution effected by the conversion may occur no more than 1/4 point away from the last sale, although this requirement may be waived with the approval of an NYSE Floor Official; and (3) the specialist cannot convert percentage orders for consecutive, or contemporaneous, trades on destabilizing ticks without the approval of a Floor Governor. See also NYSE Rule 123A.30. With regard to conversions made to better the market, the 1987 Order noted that the NYSE's proposal permitted a specialist to: (1) Convert an order on a stabilizing tick to better the market in such size as was appropriate to further the specialist's market making duties; (2) convert an order on a destabilizing tick to narrow the spread or to establish a new bid or offer immediately after a transaction had cleared the floor of bids and offers, provided that the conversion was within 1/8 point of the last sale; and (3) convert an order on a destabilizing tick, exclusive of the 1/8 point requirement, to add size to a prevailing bid or offer. The NYSE's rules provide additional restrictions on bettering the market conversions. See NYSE Rule 123A.30.

<sup>11</sup> See Amex 1995 Order and NYSE 1995 Order, *supra* note 6. See also BSE 1996 Order and CHX 1995 Order, *supra* note 6 (finding that stopped orders are equivalent to limit orders because they would be elected automatically after a transaction takes place on the primary market at the stopped price).

<sup>12</sup> Specifically, on the Amex and the NYSE, a specialist may stop an order in a minimum variation market only where there is a substantial imbalance on the opposite side of the market from the order being stopped. In this situation there is an increased likelihood of price improvement for the stopped order. In addition, NYSE Rule 116.30 and Amex Rule 109(c) provide that an order to which a specialist grants a stop may not exceed

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<sup>3</sup> See H. Rep. No. 1383, 73d Cong., 2d Sess. 22; S. Rep. 792, 73d Cong., 2d Sess. 18 (1934).

<sup>4</sup> A percentage order is a limited price order to buy or sell 50% of the volume of a specified stock after the percentage order is received by a specialist. A percentage order is essentially a memorandum entry left with a specialist that becomes a "live" order capable of execution when either: (i) All or part of the order is elected as a limit order on the specialist's book based on trades in the market; or (ii) a specialist holding a percentage order with a conversion instruction converts all or part of the percentage order into a limit order to make a bid or offer or to participate directly in a trade. See New York Stock Exchange, Inc. ("NYSE") Rules 13 and 123A and American Stock Exchange LLC ("Amex") Rules 131 and 154. The conversion instruction authorizes the specialist to convert all or part of a percentage order into a limit order and to be on parity with the converted percentage order.

<sup>5</sup> An agreement by a specialist to "stop" securities at a specified price constitutes a guarantee by the specialist of the purchase or sale of the securities at the specified price or better. "Stopping" stock should not be confused with a stop order, which is an order designated as such by the customer that requires the specialist to buy (sell) a security once a certain price level has been reached.

<sup>6</sup> See Exchange Act Release Nos. 40722 (November 30, 1998), 63 FR 67966 (December 9, 1998) (permitting a NYSE specialist to elect a percentage order based on the election of a previously elected or converted percentage order on the opposite side of the market); 39837 (April 8, 1998), 63 FR 18244 (April 14, 1998) (approving the NYSE's proposal to permit "immediate execution or cancel election" percentage orders); 39009 (September 3, 1997), 62 FR 47715 (September 10, 1997) (approving the NYSE's proposal to allow a converted percentage order to retain its priority on the book when a higher bid (lower offer) is made) and to permit a "last sale-cumulative volume" instruction, which provides that if an elected portion of a percentage order placed on the book