

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50590; File No. SR-CHX-2004-36)

October 26, 2004

Self-Regulatory Organizations; Chicago Stock Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Pilot Rule Change Relating to Transactions in Certain Exchange-Traded Funds

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on October 25, 2004, the Chicago Stock Exchange, Incorporated (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (the “Commission”) the proposed pilot rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. The Exchange filed the proposed rule change pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6)⁴ thereunder, which renders the rule change effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the interpretation from interested persons.

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

In its submission, the Exchange submitted a proposed rule change to CHX Article XX, Rule 37(a), which governs manual execution of eligible market and marketable limit orders. The proposed rule change, which will remain in effect for a 60-day pilot period expiring December 24, 2004, permits a CHX specialist, acting in its principal capacity, to manually execute an incoming market or marketable limit order in three exchange-traded funds at a price other than

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

the national best bid or offer. The text of the proposed rule change is available at the Office of the Secretary, CHX and at the Commission.

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

In its filing with the Commission, the CHX included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. The CHX 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

On August 28, 2002, the Commission issued an order granting a de minimis exemption (the “Exemption”) for transactions in certain exchange-traded funds (“Exempt ETFs”)⁵ from the trade-through provisions of the Intermarket Trading System (“ITS”) Plan.⁶

According to the CHX, as stated by both Commission staff and commissioners at an open meeting on August 27, 2002, rapid-fire quotations and executions in Exempt ETFs occur consistently throughout the trading day within a range around the NBBO, rendering it extremely difficult, if not impossible, to access liquidity at an exact NBBO price point. Compounding the

⁵ The three affected Exempt ETFs are the exchange-traded funds tracking the Nasdaq-100 Index (“QQQ”), the Dow Jones Industrial Average (“DIAMONDS”) and the Standard & Poor’s 500 Index (“SPDRs”).

⁶ See Securities Exchange Act Release No. 46428 (August 28, 2002). At present, the Exemption extends to transactions that are “executed at a price that is no more than three cents lower than the highest bid displayed in CQS and no more than three cents higher than the lowest offer displayed in CQS.”

“flickering” noted by the Commission, the Exchange has noted a marked increase in the incidence of locked and crossed markets in Exempt ETFs.

CHX Article XX, Rule 37(a), commonly referred to as the Exchange’s “Best Rule,” requires that with respect to any market or marketable limit order not executed automatically, a CHX specialist must “. . . either (a) manually execute such order at a price and size equal to the NBBO price and size at the time the order was received; or (b) act as agent for such order in seeking to obtain the best available price for such order on a marketplace other than the Exchange, using order routing systems where appropriate.”

According to the CHX, given the unique environment in which the ETFs are traded, and the difficulty that CHX represents that its specialists often encounter in accessing NBBO price points, the Exchange’s Department of Market Regulation (the “Department”) believes that its enforcement of the BEST Rule must take the ETF trading environment into account when the Department evaluates the execution prices of eligible market and marketable limit orders for Exempt ETFs. The Department believes that in certain instances, execution of an order in an Exempt ETF at a price other than the NBBO may nonetheless be consistent with the specialist’s best execution obligation, in light of the unique environment that characterizes trading in Exempt ETFs. The Exchange believes that the current version of the BEST Rule contains sufficient latitude with respect to an order executed by a CHX specialist acting as agent for the order,⁷ but does not contemplate any flexibility for specialists acting in their principal capacity.⁸

Accordingly, the Exchange is submitting the proposed rule change, which permits a CHX

⁷ The Best Rule provision governing manual agency executions obligates the CHX specialist to seek “. . . the best **available** price.” CHX Article XX, Rule 37(a)(2).

⁸ The Best Rule provision governing manual principal executions obligates the CHX specialist to execute the order at the “. . . **NBBO price and size** at the time the order was received.” CHX Article XX, Rule 37(a)(2).

specialist, acting in its principal capacity, to manually execute an incoming market or marketable limit order in an Exempt ETF at a price other than the NBBO.⁹

Significantly, the proposed rule change is not intended to excuse a CHX specialist from its best execution obligations with respect to manually-executed orders. Moreover, the proposed rule change only relates to orders that are executed manually, when a CHX specialist's ability to obtain liquidity at an exact NBBO price point is extremely limited. Orders that are executed automatically will continue to be executed by the Exchange's MAX automated execution system at the NBBO in effect at the time the order is received.

2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b) of the Act.¹⁰ The CHX further believes the proposal is consistent with Section 6(b)(5) of the Act¹¹ in that it is designed to promote just and equitable principles of trade, to remove impediments to, and to perfect the mechanism of, a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

⁹ The CHX represents that this rule change is closely analogous to the Exchange's previously submitted interpretation regarding execution of resting limit orders in Exempt ETFs. Under the limit order interpretation, CHX specialists need not provide execution guarantees for Exempt ETFs, based on trade-throughs by other markets, that CHX specialists typically provide to all other listed issues. See Securities Exchange Act Release No. 46557 (September 26, 2002), 67 FR 61941 (October 2, 2002).

¹⁰ 15 U.S.C. 78(f)(b).

¹¹ 15 U.S.C. 78f(b)(5).

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

C. Self-Regulatory Organization’s Statement on Comments Regarding the Proposed Rule Change Received from Members, Participants or Others

No written comments were either solicited or received.

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

The foregoing rule change has been filed by the Exchange as a “non-controversial” rule change pursuant to Section 19(b)(3)(A)(i) of the Act¹² and subparagraph (f)(6) of Rule 19b-4 thereunder.¹³ Consequently, because the foregoing rule change: (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for thirty days from the date on which it was filed or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4 thereunder.¹⁴

A proposed rule change filed under Rule 19b-4(f)(6)¹⁵ normally does not become operative prior to thirty days after the date of filing. However, pursuant to Rule 19b-4(f)(6)(iii), the Commission may designate a shorter time if such action is consistent with the protection of investors and the public interest. The Exchange seeks to have the proposed rule change become operative immediately so that its specialists may begin trading in accordance with the proposed

¹² 15 U.S.C. 78s(b)(3)(A)(i).

¹³ 17 CFR 240.19b-4(f)(6).

¹⁴ The Commission has waived the requirement that the Exchange provide the Commission with written notice of its intent to file the proposed rule change at least five days prior to the filing date.

¹⁵ 17 CFR 240.19b-4(f)(6).

rule change. The Commission, consistent with the protection of investors and the public interest, has determined to make the proposed rule change effective as of the date of this notice.¹⁶ The Commission notes that the execution guarantees provided by the Exchange are made on a voluntary basis by the Exchange, and that a specialist's duty of best execution will in no way be affected by this proposed rule change.

At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

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. Please include File Number SR-CHX-2004-36 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CHX-2004-36. This file number should be included on the subject line if e-mail is used. To help the Commission process and review

¹⁶ For purposes of only accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

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 in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal offices of the CHX. 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 File Number SR-CHX-2004-36 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

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Assistant Secretary

¹⁷ 17 CFR 200.30-3(a)(12).