

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 52652; File No. SR-CHX-2004-17)

October 21, 2005

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Order Approving Proposed Rule Change to Amend Article XX, Rule 37(a)(3) to Eliminate its Requirement that Specialists Guarantee Execution of Limit Orders When Certain Conditions Occur in Another Market

I. Introduction

On June 21, 2004, the Chicago Stock Exchange, Inc. (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), 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> a proposed rule change to amend Article XX, Rule 37(a)(3) of its rules to permit, rather than require, CHX specialists to guarantee execution of limit orders when certain conditions occur in another market. On July 5, 2005, the CHX filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for comment in the Federal Register on July 14, 2005.<sup>4</sup> The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

II. Description of the Proposal

The Exchange proposes to amend Article XX, Rule 37(a)(3), which provides for execution of resting limit orders based on activity in other markets, to eliminate the requirement that CHX specialists guarantee execution of such limit orders when certain conditions occur in another market. For listed issues, the current rule generally obligates

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

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

<sup>3</sup> See Amendment No. 1.

<sup>4</sup> See Securities Exchange Act Release No. 51997 (July 8, 2005), 70 FR 40760.

a CHX specialist to guarantee execution of limit orders resting in the specialist's book when the issue is being traded in the primary market at a price equal to or better than the limit price. [For Nasdaq securities, the rule permits, but does not require, a CHX specialist to guarantee execution of limit orders resting in the specialist's book, when another market center's quotation locks or crosses the limit price.] The CHX represents that the guarantees set forth in Article XX, Rule 37(a)(3), commonly referred to as "limit order protection" or "primary market protection," were voluntarily adopted by the Exchange over 15 years ago to attract order flow.

Under the proposed revision to Article XX, Rule 37(a)(3), the mandate that CHX specialists guarantee execution of resting limit orders for listed issues, based on triggering activity in other markets, would be deleted. Instead, the amended rule would permit CHX specialists to continue to provide such limit order protection guarantees solely on an issue-by-issue basis, on non-discriminatory terms approved by the Exchange. The Exchange's existing functionality providing for automated execution of resting limit orders would remain available for CHX specialists who elect to continue to guarantee limit order protection.<sup>5</sup>

The CHX provided the following rationale for the proposed rule change. First, as the industry has evolved, the Exchange's principal competitors for order flow, namely "third market" execution venues and alternative trading systems, do not provide

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<sup>5</sup> The CHX anticipates that for the foreseeable future, CHX specialists would continue to provide limit order protection voluntarily using the criteria for limit order protection previously set forth in Article XX, Rule 37(a)(3). Should the CHX receive a request from a specialist to alter the voluntary limit order protection criteria and agree to alter the functionality, the Exchange will notify all CHX participants of the change. The Commission believes any such change would need to be filed pursuant to Section 19(b) of the Act.

comparable limit order protection guarantees. In addition, CHX order-sending firms now have free access to comprehensive monthly order execution quality statistics; thus, the CHX believes that “front-end” execution guarantees are no longer necessary to attract order flow. Accordingly, the Exchange believes that the guarantee no longer serves a clear competitive purpose. Secondly, since the securities industry converted to decimal trading, the availability of liquidity at a best bid or offer price has declined, making it difficult for the CHX specialist, who chooses to offset his positions in another market, to access liquidity at the price the rule requires him to provide. Consequently, the Exchange believes it is no longer appropriate to mandate that specialists guarantee execution of resting limit orders for listed issues based on activity in other market centers.

### III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>6</sup> and, in particular, the requirements of Section 6(b)(5) of the Act<sup>7</sup> because it is 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. The Commission agrees that the environment has changed significantly since the Exchange voluntarily enacted its rule-based execution guarantees, and that consequently, the guarantees may no longer serve to foster competition between the markets.

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<sup>6</sup> In approving this proposed rule change, as amended, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>7</sup> 15 U.S.C. 78f(b)(5).

However, the Commission emphasizes that the deletion of the rule-based mandate regarding limit order protection does not in any way affect a CHX specialist's obligation to provide best execution, nor would it modify any other specialist obligations set forth in Article XXX of the CHX Rules. The Exchange must continue its surveillance of order executions to ensure that CHX specialists meet all of their obligations to each order. The Commission further emphasizes that, to the extent limit order protection guarantees are provided on a voluntary, issue-by-issue basis, such guarantees would have to be provided on a non-discriminatory basis.

#### IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>8</sup> that the proposed rule change (SR-CHX-2004-17), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

Jonathan G. Katz  
Secretary

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<sup>8</sup> 15 U.S.C. 78s(b)(2).

<sup>9</sup> 17 CFR 200.30-3(a)(12).