



ORDER EXECUTION SERVICES HOLDINGS, INC.
194 Nassau Street, Suite 30, Princeton, NJ 08542

October 10, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-CHX-2006-05, Release Number 34-54550

Dear Ms. Morris:

Order Execution Services Holdings, Inc. ("OES") submits to the Securities and Exchange Commission ("Commission") this comment letter regarding the Chicago Stock Exchange Inc.'s ("CHX") rule change, SR-CHX-2006-05, to amend its rules in order to implement a new trading model. The Commission granted accelerated approval to this rule filing and its two amendments.

OES is concerned with the ramifications of this approval order because:

- 1) it is inconsistent with Rule 3b-16
- 2) is contrary to previous precedent set by the Commission, and
- 3) it authorizes exchanges to perform agent duties that are defined to be the required roles performed by broker-dealers.

Non-Discretionary Routing Decisions Versus Discretionary Routing Decisions

Under the new Order Protection Rule of SEC Rule 611, exchanges and other trading centers will be forbidden from trading at a certain price when a better protected price exists on another market. Under this new regime, exchanges will routinely route orders - *without discretion* - to market centers disseminating better prices. OES believes that it is consistent with Rule 3b-16 and prior Commission precedent for exchanges to make these *non-discretionary* routing decisions. The central concern, which we will discuss below, is caused when an exchange makes *discretionary decisions* on when, how and where to route orders when the protocol for these decisions is not defined or required by rule.



An example of a *non-discretionary routing* scenario is:

Exchange 1 has an automated quote with its best bid being 10.00 for symbol ABC.

Exchange 2 has an automated quote with its best bid being 10.01 for 1000 shares in symbol ABC.

The National Best Bid or Offer (“NBBO”) in ABC is 10.01 bid (only Exchange 2) and 10.02 offer.

Exchange 1 receives an order to sell 500 shares of ABC at 10.00. Exchange 1’s trading system routes an order via a third-party broker-dealer to Exchange 2 based on routing instructions from Exchange 1. The order receives an execution at 10.01 at Exchange 2.

Examples of *discretionary routing* scenarios are:

Scenario 1:

Exchange 1 has an automated quote with its best bid being 10.00 for symbol ABC.

Exchange 2 has an automated quote with its best bid being 10.01 for 1000 shares in symbol ABC.

Exchange 3 has an automated quote with its best bid being 10.01 for 1000 shares in symbol ABC.

The National Best Bid or Offer (“NBBO”) in ABC is 10.01 bid (both Exchange 2 and 3) and 10.02 offer.

Exchange 1 receives an order to sell 500 shares of ABC at 10.00. Exchange 1’s trading system routes an order via a third-party broker-dealer to Exchange 3 based on routing instructions from Exchange 1. The order is executed at 10.01. The basis for this routing is that Exchange 3 has lower quote access fees than Exchange 2.

Scenario 2:

Exchange 1 has an automated quote with its best bid being 10.00 for symbol ABC.



Exchange 2 has an automated quote with its best bid being 10.01 for 1000 shares in symbol ABC.

Exchange 3 has a manual quote with its best bid being 10.02 for 1000 shares in symbol ABC.

The National Best Bid or Offer (“NBBO”) in ABC is 10.02 bid (Exchange 3) and 10.03 offer.

Exchange 1 receives an order to sell 500 shares of ABC at 10.00. Exchange 1’s trading system routes an order via a third-party broker-dealer to Exchange 2 based on routing instructions from Exchange 1. The order is executed at 10.01. The basis for this routing is that Exchange 2’s bid was an automated quote versus the manual quote being displayed by Exchange 3.

OES believes Exchange 1 in both scenario 1 and 2 is acting with fiduciary responsibilities as agent, using discretion on when, how and where to route an order based on its interpretation of what terms are in the customer’s best interests. OES asserts that acting as an agent with discretionary capabilities is outside the definition of an exchange. In order to perform as an agent, the exchange needs a broker-dealer within its exchange structure which is authorized to implement these decisions regarding best execution. That is, the exchange needs to add the missing component that gives it authority to do things outside of what has been defined by rule, precedent or interpretation.

Use of Discretion Impacts the Definition of an Exchange

In an excerpt from the approval order for SR-CHX-2006-05, it is stated:

In providing the routing services, the Exchange would use its own systems to determine when, how, and where orders (or commitments) are routed away to other markets. (Emphasis added)

OES asserts that this filing will make the CHX, through its powers to use discretion on when, how, and where orders are routed (and thus implement best execution decisions), an agent to its members with fiduciary responsibilities.

The definitions found in the Exchange Act establish that the purpose of an exchange is to be a market place that brings together buyers and sellers so that these parties can agree on the terms of a trade. Furthermore, a broker-dealer is the party that acts as an agent for the buyer or seller of a trade. An exchange is a market place and a broker-dealer is an agent. Therefore, OES asserts that the CHX needs a facility broker-dealer through which discretionary routing logic can be implemented.



The CHX proposes to provide its routing services pursuant to the terms of three separate agreements. The contract between the CHX and its members includes an agreement for the CHX to provide routing services to each member. However, the member does not have the authority to grant the CHX the ability to provide broker-dealer services wherein it will act as a *discretionary agent* implementing order handling. Therefore, the CHX and the Commission erred in their approach to contractually establish - in a chain of agreements - the legal framework for providing routing services.

The Commission defined many facets of what differentiates an exchange from an alternative trading system or a broker-dealer in Reg ATS. The Commission revised its Rule 3b-16 to define an exchange to mean any organization, association, or group of persons that:

- 1) brings together the orders of multiple buyers and sellers; and
- 2) uses established, *non-discretionary* methods under which such orders interact with each other, and that the buyers and sellers entering such orders agree to the terms of a trade.

In the Reg ATS Approval Order, the Commission uses an example of block trading desks (an “agent”) using discretion in determining how to execute a customer order. The discretion may include “shopping” the order in an attempt to find contra-side interest at the order’s terms. The outbound router services of the CHX will have similar discretion when deciding how to route an order when multiple market centers are simultaneously displaying the best price by making a choice with “smart” routing logic where to route the order.

A similar use of discretion will be made by the CHX when it is deciding how to route an order when a non-protected quote has a better price than the next-best price that is disseminated in a protected quote. The CHX will be taking on the role of an agent in implementing the routing decision that satisfies best execution.

Exchange Facilities “Bring Together” Buyers and Sellers

The Commission changed Rule 3b-16 to exclude certain systems, including those that merely route orders to other facilities for execution. Reg ATS helped the Commission adapt what is generally understood to be an exchange to reflect changes brought about by automated trading, but it continued to reflect the basic concept that an exchange brings together buying and selling interests.



The rule requires that the exchange “bring together” orders and trading interests entered on its system or represented to its system users. Therefore, it suggests that exchange facilities bring together both buyers and sellers in order to trade based on established terms and conditions. “Bringing together” does not include an external buyer or seller.

The Commission, as stipulated in Reg ATS, requires that the methods to bring the parties together have to be “non-discretionary.” The Commission’s rules and requirements support the position that in order to have discretion, the handler of the order needs to be an agent.

The Commission also said it intended for “established, non-discretionary methods” to include methods that dictate the terms of trading among buyers and sellers entering orders into the exchange’s system. The Commission clarifies this point by stating that, “Rules that merely supply the means of communication with a system ... do not satisfy this element of Rule 3b-16.”

Lastly, the Commission stated that a trading system that falls within the interpretation of “exchange” is a system which will match a buy order and a sell order and route them to another exchange for execution. The outbound router services of the CHX only have one side of a trade - that is, a buy order or a sell order. This classification does not match the current definition of an exchange.

Excerpt from Reg ATS: Systems Excluded From Rule 3b-16

The Proposing Release specifically excluded from the proposed, revised interpretation of “exchange” several types of activities that could be considered traditional brokerage activities: order routing systems, dealer quotation systems, and internal broker-dealer order management and execution systems. Commenters widely agreed that automated broker-dealer functions should not be encompassed in the meaning of “exchange.” The Commission agrees. (Emphasis added)

The Commission does not believe that these routing systems meet the two-part test in paragraph (a) of Rule 3b-16 because they do not bring together orders of multiple buyers and sellers. Instead, all orders entered into a routing system are sent to another execution facility. In addition, routing systems do not establish non-discretionary methods under which parties entering orders interact with each other.

OES contends that these last two paragraphs, which were extracted from Reg ATS, establish that routing systems are broker-dealer functions and cannot be performed by an



exchange. OES would also argue that an order routed away needs to have a broker-dealer agent representing its interest in order to fulfill its fiduciary duty.

OES asserts that the CHX' outbound routing arrangement does not satisfy the Commission's requirements because it:

- 1) does not bring together a buyer and seller within its system
- 2) is a means of communication with another market center's system

CHX Is Incorrect In Its Response to OES' Comment Letter

In its Amendment Number Two, the CHX states:

OES's argument does not recognize fundamental distinctions between the Wave arrangement and the order routing services that the CHX proposes to provide. In the Wave arrangement, an affiliated broker-dealer made the routing decisions on behalf of that exchange's participants, and then the exchange's order-routing functionality routed the orders in accordance with the broker-dealer's routing decisions. Accordingly, the CHX believes that the OES Comment Letter raises erroneous considerations, and need not be further addressed.

In response, OES' argument was not erroneous and - to clearly show that the CHX has its facts wrong - OES points to the following:

- 1) The Commission's approval order for SR-PCX-00-25 clearly describes the routing decision originating from ArcaEx:
 - i. *Specifically, pursuant to contract, Wave would receive instructions from ArcaEx, would route orders away in accordance with those instructions, and would be responsible for reporting resulting executions back to ArcaEx.* (Emphasis added)
- 2) Broker-dealers that are outbound router facilities of exchanges do not produce and publish SEC Rule 606 reports on order routing information for non-directed orders. The reason for this is because the facility broker-dealers consider all of the order flow received for outbound routing as being directed by their affiliated exchange. *It is the exchange that determines routing logic, implemented through its affiliated broker-dealer, the broker-dealer is not making independent routing decisions.*

The Commission in its approval order noted that, "the third-party broker-dealer will not be owned by CHX or an affiliate of CHX" as further justification for its position that the third-party broker-dealer does not necessarily need to be deemed a facility of the CHX. OES wishes to point out that in its approval order for SR-PCX-00-25, the Commission did not place great emphasis or importance on ownership of the broker-dealer as the basis for requiring that Wave be a facility of the PCX. Based on OES' interpretation of the approval order, the apparent basis of the exchange facility requirement was that the



outbound router broker-dealer was specifically endorsed by the exchange and it held a special position with respect to the affiliated exchange's operations and structure.

In its August 25, 2006 comment letter, OES asserted that the third-party broker-dealer arrangement with the CHX satisfied the relevant requirements specified by the Commission to designate it as an Exchange Facility. That is:

- 1) the "specified third-party broker-dealer" occupies a special position with respect to CHX;
- 2) the "specified third-party broker-dealer" is uniquely linked to and endorsed by CHX; and
- 3) the "specified third-party broker-dealer" would operate as a system of communications to or from the CHX.

Summary

A number of exchanges have responded to the outbound routing challenges of Reg NMS and their new exchange trading models. Many of these exchanges have proposed new rules that include an exchange facility broker-dealer (as defined in Section 3(a)(2) of the Exchange Act) responsible for acting as agent and making routing decisions (as fully defined and controlled by the affiliated exchange).

OES believes that the Commission's rules, interpretations and precedent of previous decisions all support the requirement for a facility broker-dealer to perform the agent role, implementing discretionary decisions on how to best handle a member's order. As described, the CHX should be required to establish - as part of its order routing services - a facility broker-dealer through which the CHX will determine when, how and where orders are routed. Otherwise, this accelerated approval order from the Commission will redefine an exchange to include broker-dealer responsibilities.

The CHX amendment and the subsequent Commission approval erred in blurring the functional distinctions between an exchange and a broker-dealer. The long-term consequences of this decision could dramatically alter the securities industry. To recap:

- 1) exchanges, by definition, cannot implement discretionary best execution routing decisions;
- 2) exchanges can only control and set parameters for *discretionary routing* decisions implemented through an affiliated broker-dealer;
- 3) the affiliated broker-dealer - with its agent and fiduciary capabilities - is the appropriate entity to be held responsible for satisfying the client's best interests;
- 4) broker-dealers that are uniquely endorsed and linked with an exchange have previously been required by the Commission to be an exchange facility, as defined in Section 3(a)(2) of the Exchange Act.



OES appreciates this opportunity to submit to the Commission our views on this filing, and we appreciate serious consideration of our assertions by all parties. Please feel free to contact me at (609) 430-4979, or by email at mbarth@tradeoes.com.

Sincerely,

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Senior Vice President
Exchanges and Market Centers
Order Execution Services Holdings, Inc.