

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54550; File No. SR-CHX-2006-05)

September 29, 2006

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Order Approving a Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 Thereto to Implement a New Trading Model

I. Introduction

On February 2, 2006, 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 its rules to implement a new trading model that provides the opportunity for fully automated executions to occur within a central matching system (the “Matching System”). On August 10, 2006, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as amended by Amendment No. 1, was published for comment in the Federal Register on August 18, 2006.<sup>3</sup> The Commission received one comment letter on the proposal.<sup>4</sup>

On September 29, 2006, the Exchange filed Amendment No. 2 to the proposed rule change.<sup>5</sup> This order approves the proposed rule change, as amended by Amendment No. 1.

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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 Securities Exchange Act Release No. 54301 (August 10, 2006), 71 FR 47836 (“Trading Rules Notice”).

<sup>4</sup> See Letter from Michael A. Barth, Senior Vice President, Exchanges and Market Centers, Order Execution Services Holdings, Inc. (“OES”), to Nancy M. Morris, Secretary, Commission, dated August 25, 2006 (“OES Letter”).

<sup>5</sup> See Form 19b-4 dated September 29, 2006 (“Amendment No. 2”). The text of Amendment No. 2 is available on CHX’s Web site (<http://www.chx.com>), at the principal office of CHX, and at the Commission’s Public Reference Room. See infra Section II.E for a discussion of Amendment No. 2.

Simultaneously, the Commission is providing notice of filing of, and granting accelerated approval to, Amendment No. 2 to the proposed rule change.

## II. Description

The Exchange proposes to amend its rules in order to implement a new trading model that would allow Exchange participants to interact in a fully-automated Matching System. In addition, the proposed rules would enable qualifying participant firms to register as “institutional brokers,” that, among other things, would be permitted to execute transactions outside of the Matching System under specified conditions.<sup>6</sup> Many of the features of the new trading model are designed to comply with Regulation NMS<sup>7</sup> as of the “Trading Phase Date” for the implementation of that regulation – February 5, 2007.<sup>8</sup> The Exchange is also proposing a number of other changes to its rules in an effort to update them generally, as well as to reflect the elimination of the trading floor and the new automated trading system that will be central to the Exchange’s new trading model.

### A. The Matching System

The Matching System would be the core facility of the Exchange’s new trading model. The Exchange would no longer operate a physical trading floor, but rather would operate an automated Matching System where Exchange participants could submit orders from any location for possible immediate execution.

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<sup>6</sup> See infra Section II.C. for a more detailed discussion.

<sup>7</sup> 17 CFR 242.600 et seq.

<sup>8</sup> See infra note 27.

1. Eligible Orders and Order Types

The Matching System generally would accept orders that are day orders, limit orders, and orders for regular way settlement.<sup>9</sup> Orders could be submitted as round lots, odd lots, or mixed lots, except that orders in securities that only trade in specific share size increments would be required to be submitted only in those share sizes.<sup>10</sup> The Exchange believes that its quotations would qualify as “automated quotations” under Rule 600(b)(3) of Regulation NMS.<sup>11</sup>

Some of the order types accepted by the Matching System that the Exchange describes as more routine would include immediate or cancel (“IOC”) limit and market orders,<sup>12</sup> fill or kill (“FOK”) orders,<sup>13</sup> sell short and short exempt orders,<sup>14</sup> reserve size orders,<sup>15</sup> time in force orders<sup>16</sup> and cancel on halt orders.<sup>17</sup> The Matching System also would accept several different

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<sup>9</sup> See proposed CHX Article 20, Rule 4(a)(1)-(3). The proposed rules provide for certain exceptions to these basic order eligibility requirements. For example, the Matching System would also accept immediate-or-cancel (“IOC”) market orders, and would permit a “non-regular way cross order” to be submitted for execution and non-regular way settlement. See proposed CHX Article 20, Rules 4(a)(7) and 4(b)(13) and (16).

<sup>10</sup> See proposed CHX Article 20, Rule 4(a)(4).

<sup>11</sup> See 17 CFR 242.600(b)(3). The Exchange’s proposed rules provide that each order submitted to the Matching System must be a firm order and cannot be identified as a “manual” quotation. See proposed CHX Article 20, Rule 3(a). See also *infra* note 54 and accompanying text.

<sup>12</sup> IOC orders would be executed against any orders at or better than the Exchange’s Best Bid or Offer (“BBO”), including any reserve size or other undisplayed orders at or better than that price. See proposed CHX Article 20, Rules 4(b)(12) (IOC orders) and 4(b)(13) (IOC market orders).

<sup>13</sup> See proposed CHX Article 20, Rule 4(b)(11).

<sup>14</sup> See proposed CHX Article 20, Rule 4(b)(21) (sell short orders) and Rule 4(b)(22) (short exempt orders).

<sup>15</sup> See proposed CHX Article 20, Rule 4(b)(20).

<sup>16</sup> See proposed CHX Article 20, Rule 4(b)(23).

<sup>17</sup> See proposed CHX Article 20, Rule 4(b)(3).

types of cross transactions, including a cross,<sup>18</sup> a cross with size,<sup>19</sup> a cross with satisfy,<sup>20</sup> a cross

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<sup>18</sup> See proposed CHX Article 20, Rule 4(b)(4). A cross transaction would be an order to buy and sell the same security at a specific price that is better than the Exchange's displayed BBO and, for securities listed on any exchange other than Nasdaq (and for Nasdaq-listed securities, when Regulation NMS is implemented in those issues), equal to or better than the National Best Bid and Offer ("NBBO"). A cross may represent interest of one or more Exchange participants, trading for a proprietary account. See infra note 43 for a description of cross order executions.

<sup>19</sup> See proposed CHX Article 20, Rule 4(b)(6). A cross with size would be required to be for at least 5,000 shares and for a value of \$100,000 that is at a price equal to or better than the Exchange's displayed BBO and, for securities listed on the New York Stock Exchange ("NYSE"), the American Stock Exchange ("Amex"), or any other exchange except the NASDAQ Stock Market ("Nasdaq") (and for Nasdaq-listed securities, when Regulation NMS is implemented in those issues), equal or better to the NBBO, where the size of the cross transaction is one round lot larger than the aggregate size of all interest displayed on the Exchange at that price. At such time as the Exchange disseminates a feed of all displayable orders in the Matching System, however, a cross with size order would be required to be larger only than the largest order in the Matching System at the relevant price. See Amendment No. 2. A cross with size transaction may represent interest of one or more participants of the Exchange. See also infra note 43.

<sup>20</sup> See proposed CHX Article 20, Rule 4(b)(5). A cross with satisfy is designed to provide a participant with a mechanism for clearing out displayed orders in the Matching System that would otherwise have time priority (or displayed bids or offers in other market centers that would otherwise have price priority) and then effecting a cross transaction at that price. A cross with satisfy could represent interest of one or more participants of the Exchange but, to the extent that it represents interest of the participant sending the order to the Matching System, the participant (i) would not be eligible to satisfy existing bids or offers in the Matching System at a price that is better than the cross price (when the participant's customer is on the same side of the order as the participant), and (ii) could only satisfy bids or offers in other markets at a price that is better than the cross price if the cross is for at least 10,000 shares or has a value of at least \$200,000 (a "block size order") or is for the account of an institutional customer (defined elsewhere in the proposed rules) and the participant's customer has specifically agreed to that outcome. See also infra note 44.

with yield,<sup>21</sup> a midpoint cross,<sup>22</sup> an ISO cross,<sup>23</sup> an opening cross,<sup>24</sup> and a non-regular way cross.<sup>25</sup>

The Matching System also would accept several order types that are related to Regulation NMS,<sup>26</sup> and that would become effective on the Trading Phase Date of Regulation NMS.<sup>27</sup> For example, the Matching System would accept benchmark orders that meet the requirements of Rule 611(b)(7) of Regulation NMS.<sup>28</sup> The Matching System would also

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<sup>21</sup> See proposed CHX Article 20, Rule 4(b)(7). A cross with yield would automatically yield interest on the buy, sell, or either side of the order to any order already displayed in the Matching System at the same or better price. See also *infra* note 45.

<sup>22</sup> See proposed CHX Article 20, Rule 4(b)(15). A midpoint cross would execute at the midpoint between the NBBO. However, if the NBBO is locked at the time a midpoint cross is received, the midpoint cross would execute at the locked NBBO. If the NBBO is crossed at the time a midpoint cross is received, the midpoint cross would be automatically cancelled.

<sup>23</sup> See proposed CHX Article 20, Rule 4(b)(14), added by Amendment No. 2. An ISO cross would be defined as any type of cross order marked as required by Regulation NMS to be executed without taking any of the actions required by the Exchange's relevant rules to prevent a trade-through.

<sup>24</sup> See proposed CHX Article 20, Rule 4(b)(17). Opening cross orders would execute immediately after the primary market opens in a security, at the opening price. For securities listed on NYSE, Amex and any exchange other than Nasdaq, the opening price would be the primary market opening price. For Nasdaq-listed securities (except in the case of an initial IPO), the opening price would be the midpoint of the first unlocked, uncrossed market that occurs on or after 8:30 a.m. For Nasdaq-listed securities on the date of an IPO, the opening price would be the Nasdaq opening price. See also proposed CHX Article 20, Rule 8(c)(2).

<sup>25</sup> See proposed CHX Article 20, Rule 4(b)(16). A non-regular way cross would be designated for non-regular way settlement. These orders would be automatically executed without regard to either the NBBO or any orders for regular way settlement that might be in the Matching System.

<sup>26</sup> 17 CFR 242.600 *et seq.*

<sup>27</sup> See Securities Exchange Act Release No. 53829 (May 18, 2006), 71 FR 30038 (May 24, 2006) (setting new compliance dates for Rules 610 and 611 of Regulation NMS).

<sup>28</sup> See 17 CFR 242.611(b)(7); see also CHX proposed Article 20, Rule 4(b)(2). A benchmark order, as defined in the proposed rules, would be an order submitted by an

accept different types of intermarket sweep orders (“ISOs”), such as BBO ISOs,<sup>29</sup> outbound ISOs<sup>30</sup> and price-penetrating ISOs.<sup>31</sup>

In general, the Matching System would accept only orders that comply with the sub-penny restrictions set forth in Rule 612 of Regulation NMS.<sup>32</sup> However, contingent upon the Commission granting the necessary exemptive relief from Rule 612, the proposed rules would permit any type of cross order to be submitted to the Matching System in a sub-penny increment as small as \$0.000001, provided that no type of cross, except midpoint crosses, non-regular-way crosses and cross with size orders, would be permitted to execute at a price less than \$.01 better than any currently displayed same-sided interest available on the Matching System (or \$.0001 better when the order is priced under \$1.00).<sup>33</sup>

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institutional broker, and could be executed at any price, without regard to the protected NBBO. A benchmark order could represent interest of one or more Exchange participants.

<sup>29</sup> See proposed CHX Article 20, Rule 4(b)(1). BBO ISOs would execute against orders at the Exchange’s BBO, without regard to whether the execution would trade through another market’s protected quotation. If a BBO ISO is marked as “immediate or cancel,” any remaining balance in the order would be automatically cancelled. If a BBO ISO is not marked as “immediate or cancel,” any remaining balance in the order would be displayed in the Matching System, without regard to whether that display would lock or cross another market center. See proposed CHX Article 20, Rule 6(c)(3).

<sup>30</sup> An outbound ISO would allow an Exchange participant to ask the Exchange to execute an order on the Exchange while simultaneously routing ISOs to those other markets to execute against their protected quotations. Outbound ISOs would be executed against any eligible orders in the Matching System (including any reserve size or other undisplayed orders). Other than the routing of ISOs to other market centers, no action would be taken to prevent an improper trade-through. See proposed CHX Article 20, Rule 4(b)(18).

<sup>31</sup> See proposed CHX Article 20, Rule 4(b)(19). A price-penetrating ISO would operate much like a basic ISO, except that it would allow a participant to execute through displayed and undisplayed interest, at multiple price points, on the Exchange.

<sup>32</sup> 17 CFR 242.612.

<sup>33</sup> See proposed CHX Article 20, Rule 4(a)(7)(b). See also Amendment No. 2.

Finally, the Matching System would accept “do-not-display” and “do-not-route orders.” A do-not-display order would be an order, for at least 1,000 shares when entered, that would not be displayed in whole or in part, but that would remain eligible for execution within the Matching System.<sup>34</sup> A do-not-route order would be executed or displayed within the Matching System and could not be routed to another market center.<sup>35</sup>

## 2. Ranking and Display of Orders

All orders received by the Matching System would be ranked by price, time of receipt, and, for round-lot orders, any display instructions received with the order.<sup>36</sup> Specifically, orders received by the Matching System would be ranked as follows: (i) limit orders that are eligible to be displayed, including the displayed portion of reserve size orders, and all odd-lot and mixed-lot orders would be ranked together, at each price point, in time priority; (ii) at each price point, the undisplayed portions of reserve size orders would be ranked together in time priority and would be ranked after any displayed orders (and any odd-lot and mixed-lot orders) at that price; and (iii) orders that are received with a do-not-display instruction would be ranked together, at each price point, in time priority and would be ranked after any other orders at that price.<sup>37</sup>

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<sup>34</sup> See proposed CHX Article 20, Rule 4(b)(9).

<sup>35</sup> See proposed CHX Article 20, Rule 4(b)(10). A do-not-route order would be immediately cancelled if its execution would improperly trade through the ITS BBO or another market’s protected quotations. Any types of cross, IOC, or FOK orders would be deemed to have been received with a “do not route” condition because these orders either are immediately executed in the Matching System or cancelled.

<sup>36</sup> See proposed CHX Article 20, Rule 8(b). Orders sent to an institutional broker for handling would not have any priority within the Matching System unless and until they are received by the Matching System. Id.

<sup>37</sup> Id., proposed Rule 8(b)(1)-(3). The refreshed displayed portion of a reserve-size order would receive a new ranking based on the time it was refreshed, with any remaining undisplayed portion retaining the ranking at which it was originally received. Id., proposed Rule 8(b)(4). A change to an order’s size or price, or its displayed portion, could impact its ranking within the Matching System. A change to the display

All orders that are eligible for display would be immediately and publicly displayed through the processes set out in the appropriate transaction reporting plan for each security when they constitute the best round-lot bid or offer in the Matching System for that security. For display purposes, the Matching System would aggregate all shares, including odd-lot orders and the odd-lot portions of mixed-lot orders, at a single price point, and then round that total share amount down to the nearest round-lot amount.<sup>38</sup>

### 3. Automatic Execution

Incoming orders generally would be matched against orders in the Matching System, in the order of their ranking, at the price of each resting order, for the full amount of shares available at that price or for the size of the incoming order, if smaller.<sup>39</sup> If an order could not be immediately matched or matched in full when received, and it is not designated as an order type that should be immediately cancelled,<sup>40</sup> it or its residual portion would be placed in the Matching System and ranked.<sup>41</sup>

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instructions associated with an order would need to be submitted as a new order and would be ranked based on the time the new order was received. Id., proposed Rule 8(b)(5). See also Amendment No. 2.

<sup>38</sup> Id., proposed Rule 8(b)(6). For execution purposes, however, all orders would retain their rankings as described above.

<sup>39</sup> See proposed CHX Article 20, Rule 8(d)(1). This general rule would be subject to certain exceptions specifically set forth in proposed CHX Article 20, Rule 8(e), and subject to the provisions relating to the prevention of trade-throughs in proposed CHX Article 20, Rule 5.

<sup>40</sup> See proposed CHX Article 20, Rules 4(b)(11) through (13). Orders that would be immediately cancelled, if not executed, include FOK orders and IOC limit and market orders.

<sup>41</sup> See proposed CHX Article 20, Rule 8(d)(2); see also supra note 37 and accompanying text.



The proposed rules describe certain order types that would be subject to specific executions within the Matching System.<sup>42</sup> Such order types include cross and cross with size orders,<sup>43</sup> cross with satisfy orders,<sup>44</sup> cross with yield orders,<sup>45</sup> sell short orders,<sup>46</sup> do-not-

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<sup>42</sup> See proposed CHX Article 20, Rule 8(e).

<sup>43</sup> See proposed CHX Article 20, Rule 8(e)(1). Cross and cross with size orders would be automatically executed if they meet the requirements for such order types, and would be immediately and automatically cancelled if they do not meet these requirements.

<sup>44</sup> See proposed CHX Article 20, Rule 8(e)(4). In executing cross with satisfy orders, the Matching System first would determine whether the order contains a share size that is sufficient to satisfy orders in the Matching System or bids or offers in other markets, as applicable. If this requirement is not met, the cross with satisfy would be automatically cancelled. If the order meets this requirement, the Matching System then would satisfy existing orders in the Matching System or send orders or commitments to other market centers to satisfy bids or offers, as necessary to prevent a trade-through and, before updating the Exchange's quotes, would execute the cross at a price that is better than the best bid or offer to be displayed in the Matching System and, for securities listed on NYSE, Amex or any other exchange other than Nasdaq (and for Nasdaq-listed securities, when Regulation NMS is implemented in those issues), equal to or better than the NBBO. In doing so, the Matching System would determine whether the participant that sent the order to the Matching System is attempting to satisfy bids or offers in the Matching System at a price that is better than the cross price and, if so, would not allow those executions to occur, but would instead allocate the better prices to the customer, not to the participant sending the order to the Matching System. See also supra note 20.

<sup>45</sup> See proposed CHX Article 20, Rule 8(e)(2). A cross with yield order would be automatically executed by matching the participant as principal against the customer order if the customer order that is part of a cross with yield order is at a price better than the currently displayed best bid or offer in the Matching System; provided, however, that if there is any order already displayed in the Matching System at the same price as (or better than) the participant's interest, that order or those orders would be matched against the customer order in place of the participant's interest as necessary to exhaust the customer order interest. If the customer order that is part of a cross with yield order is not eligible for an immediate execution because it is not priced better than the currently displayed bid or offer in the Matching System, the cross with yield order would be immediately and automatically cancelled. See also supra note 21.

<sup>46</sup> See proposed CHX Article 20, Rule 8(e)(5). Sell short orders (including odd lot orders) would be displayed and executed only when permissible under the provisions of Rule 10a-1 ("Short Sale Rule") under the Act and Regulation SHO. When a sell short order cannot be executed or displayed at its limit price under the provisions of the Short Sale Rule and Regulation SHO, the order would be automatically re-priced (without violating its limit price) to the next available price at which it can be executed or displayed. If the

display orders,<sup>47</sup> and inbound ITS commitment or linkage plan orders.<sup>48</sup> The proposed rules also describe the handling of orders in locked and crossed markets.<sup>49</sup>

#### 4. Preventing Trade-Throughs

An inbound order for at least one round lot would not be eligible for execution on the Exchange if its execution would cause an improper trade-through, both prior to and following the Trading Phase Date of Rule 611 of Regulation NMS.<sup>50</sup> The proposed rules provide that the Exchange will follow a series of trade-through policies and procedures in determining whether a trade on the Exchange would create an improper trade-through.<sup>51</sup> These procedures include clock synchronization practices, as well as plans for applying the exceptions to Rule 611 of Regulation NMS. For example, the Exchange's rules contemplate using the self-help exception in Rule 611(b)(1) of Regulation NMS.<sup>52</sup> Further, the Exchange would automatically place an appropriate modifier on trades executed pursuant to an exemption from, or exception to, Rule

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Matching System cannot determine an appropriate price at which to execute or display the order, the order would be automatically cancelled. See Amendment No. 2.

<sup>47</sup> See proposed CHX Article 20, Rule 8(e)(6). A do-not-display order would be immediately and automatically cancelled if, at any point, the order would prevent the execution of an inbound order because the do-not-display order has crossed the NBBO.

<sup>48</sup> See proposed CHX Article 20, Rule 8(e)(7).

<sup>49</sup> See proposed CHX Article 20, Rule 6 and proposed CHX Article 20, Rule 5, Interpretation and Policy .01(e).

<sup>50</sup> See proposed CHX Article 20, Rule 5. An inbound order for at least one round lot would not be eligible for execution on the Exchange if its execution would cause an improper trade-through of another ITS market or if, when Regulation NMS is implemented for a security, the execution of all or a part of the order would be improper under Rule 611 of Regulation NMS. Inbound odd lot orders and odd lot crosses would be eligible for execution on the Exchange, even if they would trade through other markets' bids and offers.

<sup>51</sup> See proposed CHX Article 20, Rule 5, Interpretation and Policy .01.

<sup>52</sup> See 17 CFR 242.611(b)(1); see also proposed CHX Article 20, Rule 5, Interpretation and Policy .01(d).

611 of Regulation NMS in accordance with specifications approved by the operating committee of the relevant national market system plan for an NMS stock. If a trade is executed pursuant to both the intermarket sweep order exception of Rule 611(b)(5) or (6) of Regulation NMS and the self-help exception of Rule 611(b)(1) of Regulation NMS, the trade would be identified as executed pursuant to the intermarket sweep order exception.<sup>53</sup> The proposed rules also set forth the procedures that the Exchange would use to confirm that its own bids and offers qualify as automated quotations and, if they do not qualify as automated quotations, how the Exchange will identify such quotations as manual.<sup>54</sup>

## 5. Order Routing

The proposed rules also contain provisions governing the routing of orders to other markets when execution in the Matching System would cause an improper trade-through.<sup>55</sup> If a participant has submitted a cross with satisfy or an outbound ISO order and its execution would cause an improper trade-through, the Matching System would execute the order and simultaneously route orders or commitments necessary to satisfy the bids or offers of other markets (“routing services”). Otherwise, any inbound order for at least a round lot is not eligible for execution on the Exchange if its execution would cause an improper trade-through.<sup>56</sup> The Exchange proposes to provide these routing services pursuant to the terms of three separate agreements, to the extent that they are applicable to a specific routing decision: (i) an agreement between the Exchange and each participant on whose behalf orders will be routed; (ii) an

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<sup>53</sup> See proposed CHX Article 20, Rule 5, Interpretation and Policy .01(h). See also Amendment No. 2.

<sup>54</sup> See proposed CHX Article 20, Rule 5, Interpretation and Policy .02. Specifically, the Exchange would send test IOC orders to the Matching System to make this determination. See also supra, note 11 and accompanying text.

<sup>55</sup> See proposed CHX Article 20, Rule 5, Interpretation and Policy .03.

<sup>56</sup> See proposed CHX Article 20, Rule 5(a).

agreement between each participant and a specified third-party broker-dealer that will use its routing connectivity to other markets and serve as a “give-up” in those markets; and (iii) an agreement between the Exchange and the specified third-party broker-dealer pursuant to which the third-party broker-dealer would agree to provide routing connectivity to other markets and serve as a “give-up” for the Exchange’s participants in other markets. 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.<sup>57</sup> In addition, 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 third-party broker-dealer, and, to the extent the third-party broker-dealer reasonably receives confidential and proprietary information, that adequately restrict the use of such information by the third party broker-dealer to legitimate business purposes necessary to provide routing connectivity and to serve as a “give-up.”<sup>58</sup>

6. Locking and Crossing Quotations

With certain exceptions, Exchange participants would be required to reasonably avoid displaying, and refrain from engaging in a pattern or practice of displaying, any quotations that lock or cross a protected quotation.<sup>59</sup> An order would not be eligible for display on the Exchange if its display would improperly lock or cross the ITS best bid or offer or, as of the

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<sup>57</sup> Id.

<sup>58</sup> See Amendment No. 2, supra note 5.

<sup>59</sup> See proposed CHX Article 20, Rule 6. The exceptions are provided when: (i) the locking or crossing quotation was displayed at a time when the other trading center 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.; or (iii) the Exchange participant displaying the locking or crossing quotation simultaneously routed an intermarket sweep order to execute against the full displayed size of any locked or crossed protected quotation.

Trading Phase Date of Regulation NMS for a security, if its display would constitute a locking or crossing quotation.<sup>60</sup> These otherwise locking or crossing orders would either be automatically routed to another appropriate market or, if designated as “do not route,” automatically cancelled.

B. Market Makers

The proposed rules in Article 16 set forth the responsibilities of a participant that registers as a market maker on the Exchange.<sup>61</sup> In particular, a market maker would be required to engage in a course of dealings for its own account to assist in the maintenance, to the extent reasonably practicable, of fair and orderly markets on the Exchange. A market maker’s responsibilities would specifically include: (1) using automated systems to maintain a continuous two-sided quote, for at least a round-lot, in each of the securities in which it is registered;<sup>62</sup> (2) maintaining adequate minimum capital; and (3) meeting specific quotation or trade requirements, with respect to its dealings on the Exchange, over the course of each calendar month.<sup>63</sup> In addition, a market maker that is registered as a market maker solely on the Exchange and engages in other business activities (or that is affiliated with a broker or dealer that engages in other business activities) would be required to establish information barriers that prevent the market maker from

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<sup>60</sup> See proposed CHX Article 20, Rule 6.

<sup>61</sup> An Exchange-registered market maker would be permitted to trade only on a proprietary basis and would not be permitted to handle any agency orders on the Exchange. To the extent that a participant firm wants to act as an Exchange-registered market maker and also handle orders from customers outside the facilities of the Exchange, it would be required to create and strictly enforce information barrier procedures as described infra at note 64 and accompanying text. Since Exchange-registered market makers are not permitted to handle agency orders, the Matching Engine will reject any cross order instructions entered by a market maker in its market maker trading account. See proposed CHX Article 16, Rule 1, Interpretation and Policy .02. See also Amendment No. 2.

<sup>62</sup> A market maker’s continuous two-sided quotes would be required to be at prices which are reasonably related to the prevailing market price of the security. See CHX Article 16, Rule 8, Interpretation and Policy .01.

<sup>63</sup> See proposed CHX Article 16, Rule 8(a)-(c).

using material, non-public information or information about customer order flow handled by the firm in its trading activities.<sup>64</sup>

C. Institutional Brokers

Participant firms for which the Exchange is the designated examining authority could register with the Exchange as institutional brokers.<sup>65</sup> Institutional brokers would be deemed to be participants operating on the Exchange, although they would not effect transactions from a physical trading floor (since the Exchange will no longer have a physical trading floor) and could trade from any location. A customer order would be deemed to be on the Exchange when received by an institutional broker, but would not have priority in the Matching System until it is entered into the system.

Institutional brokers would be required to: (1) enter all orders received for execution on the Exchange into an automated system to provide an electronic record of their order handling practices; (2) handle orders with an electronic system acceptable to the Exchange that integrates their on-exchange activities with the Matching System and their trading activities in other market centers; and (3) maintain separate accounts for handling agency transactions, principal transactions, and transactions involving errors.<sup>66</sup> Institutional brokers would also be required to

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<sup>64</sup> See proposed CHX Article 16, Rule 9.

<sup>65</sup> See proposed CHX Article 17, Rule 1. Each individual that would be authorized to effect trades on behalf of the firm would be required to separately register as an institutional broker representative. See proposed CHX Article 17, Rule 1, Interpretation and Policy .02.

<sup>66</sup> See proposed CHX Article 17, Rule 3(a) through Rule 3(c). The Commission recently approved, and the Exchange has implemented, a proposed rule change regarding requirements for entering orders into an electronic system to permit the Exchange to more readily surveil broker order handling activities. See CHX Article 11, Rule 3; Securities Exchange Act Release No. 53772 (May 8, 2006), 71 FR 27758 (May 12, 2006).

maintain required records of their trading activities.<sup>67</sup> An institutional broker would be required to use due diligence to execute a market order at the best price available; to use due diligence to execute a limit order at or better than the limit price, if available; and to use brokerage judgment in the execution of a not held order.<sup>68</sup>

Institutional brokers would be required to use reasonable efforts to report all transactions that are not effected through the Exchange's Matching System to the Exchange within 10 seconds of the trade.<sup>69</sup> If an institutional broker executes an order outside of the Matching System, it would be required to use the Exchange's Brokerplex system to determine whether a trade would constitute a trade-through and create an electronic record that such validation had taken place.<sup>70</sup> In general terms, the Brokerplex system would allow an institutional broker to input the symbol for a security and pull up a window that includes a snapshot of the Matching System BBO and the NBBO. The institutional broker then could report a trade that is consistent with the orders in the Matching System and the NBBO. An institutional broker that initiates the use of this functionality to report a proprietary trade against a customer order would be required to complete the transaction report (without cancelling out of the functionality), unless the institutional broker had mistakenly input the symbol for the wrong security. The transaction also could be cancelled pursuant to CHX rules relating to cancellations of transactions, clearly erroneous transactions and systems disruptions and malfunctions.<sup>71</sup>

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<sup>67</sup> See proposed CHX Article 17, Rule 3(f).

<sup>68</sup> See proposed CHX Article 17, Rule 3(d).

<sup>69</sup> See proposed CHX Article 17, Rule 3(e).

<sup>70</sup> See CHX Article 17, Rule 3, Interpretation and Policy .03.

<sup>71</sup> See id.

Unless a customer specifically requests otherwise, an institutional broker would be required to clear the Matching System before sending an order to another market for execution.<sup>72</sup> The proposed rules provide exceptions to this requirement for: (1) outbound ITS commitments or ISOs that are being sent to another market to satisfy its displayed bid or offer;<sup>73</sup> and (2) customer orders that are being sent to another market that could not be executed in the Matching System.<sup>74</sup>

D. Other Rule Changes

Proposed Article 9, Rule 17, based on an existing Exchange rule prohibiting participants from trading ahead of customer orders, would include a provision confirming that a participant would be deemed to be holding an unexecuted customer order when that order has been sent to the Matching System, but remains unexecuted.<sup>75</sup>

The Exchange proposes to adopt a sponsored access rule, which would allow Exchange participants to provide non-participant broker-dealers with access to the Exchange.<sup>76</sup> Under the proposed rule, this type of sponsored access could be provided so long as the participant sponsoring access, the non-participant broker-dealer, and the Exchange entered into appropriate agreements confirming basic information about the parties' roles and responsibilities.<sup>77</sup>

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<sup>72</sup> See proposed CHX Article 20, Rule 7. Any customer directives for special handling of orders would have to be documented and reported to the Exchange.

<sup>73</sup> See proposed CHX Article 20, Rule 7(c).

<sup>74</sup> See proposed CHX Article 20, Rule 7(d).

<sup>75</sup> See proposed CHX Article 9, Rule 17, Interpretation and Policy .05. The proposed rule would also confirm that a participant would not be in violation of the "trading ahead" rule if it satisfied bids and offers in other markets in accordance with the requirements for a "cross with satisfy order." See proposed CHX Article 9, Rule 17, Interpretation and Policy .06; see also *supra* note 20 (discussing cross with satisfy orders).

<sup>76</sup> See proposed CHX Article 5, Rule 3.

<sup>77</sup> See *id.*



In addition to the changes described above, the Exchange has also proposed revisions to virtually every other chapter of its rules. These changes are generally designed to remove references to the physical trading floor, delete obsolete provisions and account for the new automated trading model, as well as to better streamline and organize the rules. For example, the CHX proposes to delete rules relating to specialists and access to the trading floor and adopt rules that contemplate remote access to the Exchange's automated trading systems. In addition, changes are being proposed to rules relating to: hours of trading, trading halts, cancelling transactions, business conduct, disciplinary matters and trial proceedings, arbitration, Exchange emergency suspension authority; committees; trading permits; limitation of liability; voting designees; registration; fingerprinting; reporting transactions; riskless principal transactions; use of a customer's give-up; books and records; firm supervision; ITS; clearance and settlement; and listing on the Exchange.

E. Amendment No. 2

On September 29, 2006, the Exchange filed Amendment No. 2 to the proposed rule change, which made certain revisions to the original proposal, as amended by Amendment No. 1. In Amendment No. 2, the Exchange described its proposed phase-in plan for the new trading model.<sup>78</sup> In Amendment No. 2, the Exchange also provided additional discussion and clarification on certain aspects of the proposal.

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<sup>78</sup> The Exchange stated that it plans to phase in the new trading model as follows: (i) beginning the week of October 2, 2006, the Exchange will begin to transition Nasdaq-listed securities to the Matching System; (ii) during the week of October 16, 2006, the Exchange will begin to transition all other securities that are not currently traded by specialists to the Matching System; and (iii) by early November 2006, the Exchange will begin to transition securities currently traded by the Exchange's specialists to the Matching System. The Exchange stated that, in the near future, it will provide notice to participants of the exact dates for transition of specific securities.

The Exchange also added a discussion of how the Exchange believes that the rules of the proposed new trading model will be consistent with Section 11(a) of the Act.<sup>79</sup> The Exchange stated that it believes that the proposed Matching System meets the requirements of Rule 11a2-2(T) under the Act,<sup>80</sup> known as the “effect versus execute” rule, which provides an exemption from the prohibition of Section 11(a). Further, the Exchange stated that it believes that the proposal does not raise any of the policy concerns that Congress sought to address in Section 11(a) of the Act including, specifically, the time and place advantages that members on exchange floors might have over non-members off the floor and the general public.

In Amendment No. 2, the Exchange also made certain changes to the rule text reflecting modifications in how the Matching System will operate. Specifically, the Exchange modified the proposed rules to: (1) amend the definition of a “cross with size” order;<sup>81</sup> (2) confirm that the Matching System will evaluate most cross orders to see if they meet the “cross with size” definition and, if so, will execute them as crosses with size;<sup>82</sup> (3) provide that, when the Matching System lacks sufficient information to determine the appropriate price at which a sell short order could be displayed or executed, the Matching System will automatically cancel the order;<sup>83</sup> (4) confirm that cross orders can be submitted as ISOs;<sup>84</sup> (5) remove references to

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<sup>79</sup> 15 U.S.C. 78k(a).

<sup>80</sup> 17 CFR 240.11a2-2(T).

<sup>81</sup> See proposed CHX Article 20, Rule 4(b)(6) (requiring a cross with size to size out all of the displayed interest at a price, but providing that, once the CHX is disseminating a book feed, a cross with size would only be required to size out the largest displayed order).

<sup>82</sup> See proposed CHX Article 20, Rule 4(b)(6).

<sup>83</sup> See proposed CHX Article 20, Rule 8(e)(5).

<sup>84</sup> See proposed CHX Article 20, Rule 4(b)(14).

functionality that is not being built;<sup>85</sup> and (6) confirm that a participant cannot change a “display” instruction for an order, but must submit a new order with a new display instruction.<sup>86</sup>

In addition, the Exchange revised the proposed rules to confirm the circumstances when the Matching System would display quotes that would lock or cross the protected quotes of other markets<sup>87</sup> and to clarify that the Matching System will trade in increments supported by the ITS or Regulation NMS linkage plan.<sup>88</sup> The Exchange also clarified how a trade should be identified when it is executed pursuant to both the intermarket sweep order exception of Rule 611(b)(5) or (6) of Regulation NMS and the self-help exception of Rule 611(b)(1) of Regulation NMS.<sup>89</sup>

In Amendment No. 2, the Exchange also made certain changes intended to clarify the meaning of the proposed rules. These changes include a change in the definition of NBBO to confirm that, as of the Trading Phase Date of Regulation NMS, this term relates only to protected bids and offers;<sup>90</sup> the addition of language that confirms that non-regular way crosses can execute within a penny of other orders in the Matching System;<sup>91</sup> and a change that notes that, in the last “refresh” of a reserve size order, the number of shares may be less than the original

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<sup>85</sup> See proposed CHX Article 20, Rule 4(a)(7)(b) (removing a reference to an order that executes at the midpoint of the NBBO, because this functionality is not being built at this time).

<sup>86</sup> See proposed CHX Article 20, Rule 8(b)(5).

<sup>87</sup> See proposed CHX Article 20, Rule 6(d).

<sup>88</sup> See proposed CHX Article 20, Rule 4(a)(7)(d); see also proposed CHX Article 20, Rule 4(a)(7)(e).

<sup>89</sup> See proposed CHX Article 20, Rule 5, Interpretation and Policy .01(h).

<sup>90</sup> See proposed CHX Article 1, Rule 1(o).

<sup>91</sup> See proposed CHX Article 20, Rule 4(a)(7)(b) (recognizing, as already expressed in the definition of this type of order, that non-regular way cross orders execute without regard to orders in the Matching System, because all orders in the Matching System are for regular-way settlement).

number of displayed shares because that is all that is left.<sup>92</sup> Other similar changes clarify the execution of benchmark orders;<sup>93</sup> confirm the handling of BBO ISO orders;<sup>94</sup> and state, with regard to relevant provisions, that they take effect on the Trading Phase Date of Rule 611 of Regulation NMS.<sup>95</sup>

In Amendment No. 2, the Exchange also made changes to Article 16 governing market makers. The Exchange revised the rules to prohibit an individual from registering both as a market maker trader and an institutional broker representative.<sup>96</sup> The Exchange also modified the rules to provide that market makers may only trade on a proprietary basis on the Exchange, and if a market maker handles agency orders off of the Exchange, it must create and enforce information barrier procedures pursuant to CHX Article 16, Rule 9.<sup>97</sup>

Pursuant to an exemption recently issued by the Commission,<sup>98</sup> the Exchange proposed further provisions in Amendment No. 2 to permit “qualified contingent trades” to be executed on

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<sup>92</sup> See proposed CHX Article 20, Rule 4(b)(20).

<sup>93</sup> See proposed CHX Article 20, Rule 4(b)(2) (confirming that benchmark orders must be executed in increments permitted by Article 20, Rule 4(a)(7)(b)). The Exchange also elaborated on its reasoning in proposing that benchmark orders only be permitted to be submitted to the Matching System by institutional brokers, and noted that other participants seeking to execute benchmark orders on the Exchange could do so through an institutional broker.

<sup>94</sup> See proposed CHX Article 20, Rule 4(b)(1) (confirming that BBO ISO orders will be displayed in the circumstances set out in the rule because the participant routing the order to the Matching System has already satisfied the quotations of other markets as required by Article 20, Rule 6(c)(3)).

<sup>95</sup> See, e.g., proposed CHX Article 20, Rules 4(b)(1), (2), (14), (18) and (19); see also proposed CHX Article 1, Rule 1(y) (defining the “Trading Phase Date” as February 5, 2007).

<sup>96</sup> See proposed CHX Article 16, Rule 1, Interpretation and Policy .01.

<sup>97</sup> See proposed CHX Article 16, Rule 1, Interpretation and Policy .02.

<sup>98</sup> See Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006) (“Qualified Contingent Trade Exemptive Order”).

the Exchange.<sup>99</sup> The Exchange asserts that these trades would meet the requirements of the Commission’s order exempting from Rule 611(a) any trade-throughs caused by the execution of an order involving one or more NMS stocks that are components of a “qualified contingent trade,” as defined in the Commission’s exemptive order.<sup>100</sup>

The Exchange also added provisions requiring it to establish and maintain information barriers to restrict the flow of information between the Exchange (including its facilities) and the third-party broker-dealer providing connectivity to other trading centers, and, to the extent such third-party broker-dealer receives such information, that adequately restrict the use of such information by the third party broker-dealer to legitimate business purposes necessary to provide routing connectivity and to serve as a “give-up.” Further, in Amendment No. 2, the Exchange revised its rule text to reflect recent changes made to Exchange rules by other proposed rule changes that have been recently approved by the Commission.<sup>101</sup>

### III. Discussion and Commission Findings

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>102</sup> and, in particular, the requirements of Section 6 of the Act<sup>103</sup>

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<sup>99</sup> See proposed CHX Article 1, Rule 2(bb) and proposed CHX Article 20, Rule 5, Interpretation and Policy .01(i).

<sup>100</sup> See Qualified Contingent Trade Exemptive Order, supra note 98.

<sup>101</sup> In particular, the Exchange revised the proposed rule text to reflect changes to the Exchange’s disciplinary rules made in SR-CHX-2005-06, see Securities Exchange Act Release No. 54437 (September 13, 2006), 71 FR 55037 (September 20, 2006); and to reflect changes to the Exchange’s rules made in SR-CHX-2006-23, confirming that each participant firm only needs one trading permit to conduct business on the Exchange, see Securities Exchange Act Release No. 54494 (September 25, 2006).

<sup>102</sup> The Commission has considered the proposed rule’s impact on efficiency, competition and capital formation. 15 U.S.C. 78c(f).

<sup>103</sup> 15 U.S.C. 78f.

and the rules and regulations thereunder. The Commission finds that the proposed rule change, as amended, is consistent with Section 6(b)(5) of the Act,<sup>104</sup> which requires that the rules of an exchange be designed, among other things, to prevent fraudulent and manipulative acts and practices, 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.

A. The Matching System

The Matching System would allow participants to route orders to it from any location for possible immediate execution through any communications line approved by the Exchange.<sup>105</sup> The adoption of the Exchange's proposed rules, which feature the Matching System as the core facility of the Exchange, will fundamentally change the Exchange's current market structure from a substantially floor-based auction market to an all-electronic one. The Commission believes that by allowing electronic access to Exchange liquidity, the proposed new model should help perfect the mechanism of a free and open market by providing investors with a more efficient mechanism to have their orders executed on the Exchange.

The Commission also believes that the Exchange's new trading model should facilitate securities transactions by providing investors with faster and more efficient access to the trading interest reflected in the Exchange's published quotation, as well as interest away from the Exchange BBO. Finally, the Commission believes that the Exchange's proposal should enhance the opportunity for a customer's order to be executed without dealer participation, consistent with the goals of Section 11A of the Act.<sup>106</sup>

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<sup>104</sup> 15 U.S.C. 78f(b)(5).

<sup>105</sup> See proposed CHX Article 20, Rule 8(a)(1).

<sup>106</sup> See Section 11A(a)(1)(C) of the Act, 15 U.S.C. 78k-1(a)(1)(C).

1. Eligible Orders and Order Types

Under the proposed rule change, participants would be permitted to submit orders to the Matching System that are day orders, limit orders, and orders for regular way settlement (as well as certain other excepted types of orders such as IOC market orders and non-regular way crosses) and generally would be permitted to submit orders as round lots, odd lots, or mixed lots.<sup>107</sup> The proposed rules require that orders submitted to the Matching System must meet the requirements of Rule 612 of Regulation NMS, unless an exemption therefrom applies.<sup>108</sup> As such, except for cross orders under certain circumstances as discussed below,<sup>109</sup> orders priced at or above \$1.00 could not be submitted to the Matching System in increments less than \$0.01, and orders priced less than \$1.00 could not be submitted to the Matching System in increments less than \$.0001.<sup>110</sup> The Commission believes that these order eligibility requirements are consistent with the Act.

The Exchange proposes to permit the Matching System to accept a wide variety of order types. These order types include: immediate or cancel limit and market orders, fill or kill orders, sell short and short exempt orders, reserve size orders, time in force orders, cancel on halt orders, do-not-display orders, do-not-route orders, various types of cross orders, and various types of ISOs.<sup>111</sup> Many of these order types exist in the Exchange's current rules set, while others have been proposed exclusively for use in the new trading model or for use as of the Trading Phase Date of Regulation NMS. The Commission believes that these order types should provide

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<sup>107</sup> See supra notes 9-10 and accompanying text.

<sup>108</sup> 17 CFR 242.612.

<sup>109</sup> See infra note 124 and accompanying text.

<sup>110</sup> See proposed CHX Article 20, Rule 4(a)(5).

<sup>111</sup> See supra Section II.A.1.

Exchange participants greater flexibility in reaching their trading and investment objectives. The Commission notes that a number of the proposed order types will have different definitions prior to and following the Trading Phase Date of Regulation NMS, which should enable users to make use of the trading strategies of such order types immediately, as well as after the Trading Phase Date.

As noted, the Exchange has proposed a number of cross order types for use in the Matching System. The Commission notes that the cross order is already permitted in the Exchange's electronic book.<sup>112</sup> A cross order would be immediately executed in the Matching System if it is priced better than the Matching System's displayed BBO and, for securities listed on any exchange other than Nasdaq (and for Nasdaq-listed securities, as of the Trading Phase Date of Regulation NMS), equal to or better than the NBBO.<sup>113</sup> Similarly, a form of the cross with size order is already permitted in the Exchange's electronic book.<sup>114</sup> Under the proposed rules, a cross with size will be required to be larger than the aggregate size of all displayable orders displayed on the Matching System at the cross price, consist of at least 5,000 shares, and have a value of \$100,000. The Commission notes that it has previously approved a similar rule at another exchange.<sup>115</sup>

The Exchange is also proposing several completely new cross order types that would be accepted by the Matching System, such as cross with satisfy<sup>116</sup> and cross with yield orders.<sup>117</sup> The Commission believes that these cross orders may provide an efficient means to allow

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<sup>112</sup> See current CHX Article XXA, Rule 2.

<sup>113</sup> See proposed CHX Article 20, Rule 4(b)(4) and supra note 18.

<sup>114</sup> See current CHX Article XXA, Rule 2.

<sup>115</sup> See Rules of the National Stock Exchange, Inc., Rule 11.12.

<sup>116</sup> See supra note 20.

<sup>117</sup> See supra note 21.



participants to effect cross transactions in the Matching System, consistent with the Exchange's other priority and trade-through rules, in circumstances where a cross order would otherwise be unable to be executed and would be cancelled. A cross with satisfy order would contain an instruction to execute orders already displayed in the Matching System at their limit prices (up to a specified number of shares) to the extent necessary to allow the cross transaction to occur or to route outbound orders or commitments to other market centers to the extent necessary to prevent an improper trade-through.<sup>118</sup> Once the satisfying execution has occurred, the cross order would be executed at a price that is better than the Matching System's displayed BBO and, for securities listed on any exchange other than Nasdaq (and for Nasdaq-listed securities, as of the Trading Phase Date of Regulation NMS), equal to or better than the NBBO.

The cross with yield order is similar to the cross with satisfy, and would contain an instruction to yield interest on the buy, sell, or either side of the order (as specified in the order) to any order already displayed in the Matching System at the same or better price, to the extent necessary to allow the cross transaction to occur.<sup>119</sup> The cross order would then be executed at a price that is better than the best bid or offer to be displayed in the Matching System, and, for securities listed on any exchange other than Nasdaq (and for Nasdaq-listed securities, as of the Trading Phase Date of Regulation NMS), equal to or better than the NBBO.

The Matching System would also accept mid-point cross orders, which would be executed at the midpoint of the NBBO.<sup>120</sup> The Commission notes that this order type has been previously approved for other exchanges.<sup>121</sup> The Exchange also proposes to permit a non-

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<sup>118</sup> See proposed CHX Article 20, Rule 4(b)(5).

<sup>119</sup> See proposed CHX Article 20, Rule 4(b)(7).

<sup>120</sup> See *supra* note 22.

<sup>121</sup> See, e.g., NYSE Arca Equities Rule 7.31(y).

regular way cross order, which would be for non-regular way settlement and would execute without regard to the NBBO or any other orders in the Matching System.<sup>122</sup> The Commission notes that the Exchange has represented that participants can currently execute orders for non-regular way settlement in the Exchange's electronic book and on the floor of the Exchange,<sup>123</sup> but this cross order type would be the only means to effectuate this type of transaction within the Matching System.

Contingent upon the Exchange receiving exemptive relief from the Commission, the Exchange proposes to allow all cross orders to be submitted to the Matching System in sub-penny increments as small as \$.000001, regardless of their price.<sup>124</sup> Although participants would be permitted to submit crosses in sub-penny increments, the Exchange proposes that cross orders (except for a midpoint cross, non-regular-way cross or cross with size) would be required to be priced at least \$.01 better than any order on the same side of the Matching System (or, for orders priced less than \$1.00, at least \$.0001 better than any order on the same side of the Matching System).

The Commission believes that the proposed rules relating to cross transactions are consistent with the Act and offer participants flexibility in executions which meet the specified requirements of each type of cross. In addition, the Commission notes that proposed CHX Article 9, Rule 17, which restricts trading ahead of customer orders, would apply to the cross

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<sup>122</sup> See supra note 25.

<sup>123</sup> See current CHX Article XX, Rule 9; CHX Article XXA, Rule 2(c)(5).

<sup>124</sup> See proposed CHX Article 20, Rule 4(a)(7)(b) (stating that the provision "shall take effect upon the granting of exemptive relief by the Commission").

order types, except as noted in Interpretation and Policy .06 of that rule with respect to cross with satisfy orders.<sup>125</sup>

The Exchange also proposes to permit the Matching System to accept several order types modeled on the exceptions in Rule 611(b) of Regulation NMS. The Matching System would accept various ISOs, which would allow the Exchange to immediately execute such orders without regard to other markets' protected quotations, as contemplated by Regulation NMS.<sup>126</sup> The Commission believes that these proposed order types are consistent with the Act, and notes that these provisions will not become effective until the Trading Phase Date of Regulation NMS.

The Matching System would also accept do-not-display<sup>127</sup> and do-not-route orders.<sup>128</sup> The do-not-display order could be partially or wholly undisplayed. Such an order would remain eligible for execution in the Matching System, but would be ranked behind displayed orders and behind the undisplayed portions of reserve size orders. This order type gives a participant the ability to keep trading interest unseen, but at the same time allows the order to remain eligible for execution while being ranked behind any displayed interest in the Matching System. As its name implies, a do-not-route order is an order that could not be routed to another market. A do-not-route order would be immediately cancelled if its execution would improperly trade through the ITS BBO or another market's protected quotations.<sup>129</sup> The Commission believes that these proposed order types may offer participants greater flexibility in the handling of their orders and are consistent with the Act.

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<sup>125</sup> See proposed CHX Article 9, Rule 17.

<sup>126</sup> See supra notes 29-31.

<sup>127</sup> See supra note 34 and accompanying text.

<sup>128</sup> See supra note 35 and accompanying text.

<sup>129</sup> See proposed CHX Article 20, Rule 5(a).

## 2. Ranking and Display of Orders

Under the proposed rule change, all orders received by the Matching System would be ranked by price, time of receipt, and any display instructions.<sup>130</sup> No distinction would be made with regard to agency orders and professional or proprietary orders for priority purposes.<sup>131</sup> Orders would be displayed to the public when they constitute the best round-lot bid or offer in the Matching System for a security.

Generally, incoming orders would be matched against orders in the Matching System, in the order of their ranking, at the price of each resting order, for the full amount of shares available at that price or for the size of the incoming order, if smaller.<sup>132</sup> However, orders would be subject to the proposed provisions prohibiting improper trade-throughs,<sup>133</sup> and certain order types would be subject to specific executions within the Matching System.<sup>134</sup> Unless the terms of the order direct otherwise, any order that could not be immediately executed or executed in full would be ranked in the Matching System in accordance with the Exchange's order priority rules.<sup>135</sup> In addition, the proposed rules provide that, unless a customer specifically requests otherwise, institutional brokers would be required to clear the Matching System before routing an order to another market, subject to certain exceptions.<sup>136</sup>

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<sup>130</sup> See supra notes 36-37 and accompanying text.

<sup>131</sup> The Commission has approved similar priority rules for the CHX's electronic book. See Securities Exchange Act Release No. 52094 (July 21, 2005), 70 FR 43913 (July 29, 2005).

<sup>132</sup> See proposed CHX Article 20, Rule 8(d)(1).

<sup>133</sup> See proposed CHX Article 20, Rule 5; see also supra notes 50-54 and accompanying text.

<sup>134</sup> See supra notes 43-49.

<sup>135</sup> See supra notes 40-41 and accompanying text.

<sup>136</sup> See supra notes 72-74 and accompanying text.

The Commission believes that the proposed rules relating to ranking, display and execution of orders are consistent with the Act.<sup>137</sup> In particular, the Commission believes that the priority rules and automatic execution functionality should result in a more efficient market and promote competition in the national market system. Further, the Commission believes that requiring institutional brokers to clear the Matching System before routing an order to another market is consistent with previous Exchange rules requiring members to “clear the post” prior to routing orders to other markets, which also were intended to promote interaction of orders on the Exchange.

B. Routing

The Exchange proposes to provide outbound routing services to participants for orders submitted to the Exchange that cannot be executed in whole or in part on the Exchange because of the trade-through provisions of Regulation NMS. The Exchange will use its own systems to determine when, how and where orders are routed away to other markets. To provide the necessary connectivity to transmit such orders to, and obtain executions on, other markets, the Exchange proposes to use the services of a third-party broker-dealer. The services would be provided pursuant to three separate agreements among the Exchange, the participant on whose behalf orders would be routed, and the third-party broker-dealer. The Exchange has represented that its routing services would be provided in accordance with its rules, the Act, and the rules thereunder. In particular, the Exchange routing arrangements would: (1) provide for the equitable allocation of reasonable, dues, fees, and other charges among its participants and other

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<sup>137</sup> The Exchange has represented that the Matching System meets the requirements set forth in Rule 11a2-2(T) and therefore complies with Section 11(a) of the Act. See text accompanying notes 79-80. The Commission notes that the Exchange has the obligation to enforce the provisions of the Act, including Section 11(a) thereunder.

persons using its facilities relating to the routing services; and (2) prohibit unfair discrimination among customers, issuers, brokers or dealers in connection with the routing services.

The Commission received one comment letter regarding the proposed rule change relating to routing services.<sup>138</sup> In its comment letter, OES asserted that the third-party broker-dealer described above would operate as a system of communication of the Exchange and therefore should be deemed a facility of the Exchange under Section 3(a)(2) of the Act. In Amendment No. 2, CHX responded to the OES Letter and stated its view that the third-party broker-dealer would not be a facility of the Exchange.

The Commission does not believe that the third-party broker-dealer providing connectivity to other markets as described above should necessarily be deemed to be a facility of the Exchange. Unlike the broker-dealer addressed in the Commission's Order approving the Pacific Exchange's rules establishing the Archipelago Exchange,<sup>139</sup> the third-party broker-dealer will not be owned by CHX or an affiliate of CHX. In this case, CHX will use its own systems to determine when, how, and where orders are routed away to other markets. Moreover, all of the terms and conditions for CHX members to obtain outbound routing services will be subject to CHX rules, which must be filed for approval with the Commission. The CHX rules must, among other things, provide for the equitable allocation of reasonable fees or other charges for outbound routing services and must not permit unfair discrimination among CHX members for access to the outbound routing services. CHX is contracting with an unaffiliated third-party broker-dealer solely to provide the necessary connectivity to obtain the execution of outbound orders on other markets. Given this limited role, the third-party broker-dealer should not be deemed a facility of

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<sup>138</sup> OES Letter, supra note 4.

<sup>139</sup> See Securities Exchange Act Release No. 44983 (October 25, 2001) 66 FR 55225 (November 1, 2001).

CHX under Section 3(a)(2) of the Act. Accordingly, the Commission finds that CHX's proposed routing arrangements are consistent with the Act.

C. Market Makers

Exchange market makers would be required to engage in a course of dealings to assist in the maintenance, to the extent reasonably practicable, of fair and orderly markets.<sup>140</sup> Specifically, market makers would have an obligation to maintain continuous two-sided quotes for the securities in which it is registered, at prices reasonably related to the prevailing market; to maintain adequate capital; and to meet certain monthly quotation requirements.<sup>141</sup> The proposed rules also impose other obligations on market makers, including a requirement to establish information barriers when engaging in other business activities.<sup>142</sup> These rules governing CHX market makers are similar to other exchanges' rules previously approved by the Commission.<sup>143</sup> Accordingly, the Commission believes that the proposed rules are consistent with the Act.

D. Institutional Brokers

Under the Exchange's proposed rules, institutional brokers would be considered to be "on the Exchange," and as such, customer orders received by an institutional broker would be deemed to be on the Exchange and immediately subject to the Exchange's rules.<sup>144</sup> For example, the proposed rules require that institutional brokers use an electronic system, acceptable to the Exchange, integrating an institutional broker's trading activities in the Matching System, outside

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<sup>140</sup> See proposed CHX Article 16, Rule 8.

<sup>141</sup> See id.

<sup>142</sup> See supra note 64 and accompanying text.

<sup>143</sup> See, e.g., Nasdaq Rule 4613 and NYSE Arca Equities Rules 7.23-7.26.

<sup>144</sup> See supra note 137.

of the Matching System, and in other market centers.<sup>145</sup> Additionally, because institutional brokers could execute orders outside of the Matching System but still on the Exchange, the Exchange has proposed rules to govern this activity.<sup>146</sup> First, such transactions would be required be reported to the Exchange within 10 seconds after the trade occurs. Further, the Exchange represents that it has built a functionality to allow an institutional broker to pull up a “validation window” to ensure that a trade being done outside of the Matching System does not violate trade-through provisions. In addition, to help ensure that trades outside of the Matching System are not inconsistent with an institutional broker’s fiduciary duties, once an institutional broker pulls up a validation screen, it would be required to complete the transaction and could not cancel out of the functionality, subject to certain limited exceptions.<sup>147</sup>

The Commission believes that the proposed rules governing institutional brokers should allow the Exchange to monitor appropriately the activities of institutional brokers and to help ensure that they are complying both with the rules of the Exchange and their fiduciary duties. The Commission also believes that the proposed rules will require the Exchange to carefully oversee the activities of institutional brokers, and to detect any potential abuses. Accordingly, the Commission believes that the proposed rules governing institutional brokers are consistent with the Act.

E. Regulation NMS

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<sup>145</sup> See proposed CHX Article 17, Rule 3(b).

<sup>146</sup> See supra notes 68-71 and accompanying text.

<sup>147</sup> See proposed CHX Article 17, Rule 3, Interpretation and Policy .03. The institutional broker would only be permitted to cancel out of the functionality if the broker mistakenly input the wrong symbol for the security, or the transaction may be cancelled pursuant to CHX Article 20, Rules 9, 10, or 11.



The Commission believes that the proposed rule change is consistent with the requirements of Regulation NMS.<sup>148</sup> In proposed Article 20, Rule 6, CHX proposes to adopt a rule with regard to locked and crossed markets, as required by Rule 610(d) of Regulation NMS.<sup>149</sup> The Exchange's proposed rules include marking certain orders meeting the requirements of Rule 600(b)(30) of Regulation NMS<sup>150</sup> as intermarket sweep orders and accepting orders marked as intermarket sweep orders, which would allow orders so designated to be automatically matched and executed without reference to protected quotations at other trading centers. The Commission also believes that CHX's proposed immediate-or-cancel functionality<sup>151</sup> is consistent with Rule 600(b)(3) of Regulation NMS. The Exchange has designed its proposed rules relating to orders types and eligibility<sup>152</sup> and order execution<sup>153</sup> to comply with the requirements of Regulation NMS. As noted above, these proposed rules provide that the Matching System will accept only orders (except for cross orders, as discussed above) that meet the increment requirements of Rule 612 of Regulation NMS (unless and to the extent exempted from Rule 612 by Commission order).<sup>154</sup>

In addition, as mentioned above in Section II.A, the Matching System is designed to qualify as an automated trading center under Rule 600(b)(3) of Regulation NMS.<sup>155</sup> To ensure that its systems immediately and automatically process orders, the Exchange has included in its

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<sup>148</sup> See 17 CFR 242.600 et seq.

<sup>149</sup> 17 CFR 242.610(d).

<sup>150</sup> 17 CFR 242.600(b)(30).

<sup>151</sup> See proposed CHX Article 1, Rule 2(m).

<sup>152</sup> See discussion supra Section II.A.1.

<sup>153</sup> See discussion supra Section II.A.3.

<sup>154</sup> 17 CFR 242.612.

<sup>155</sup> 17 CFR 242.600(b)(3).

rules a requirement that it use automated systems to send test IOC orders to the Matching System to determine whether it accepts the order automatically.<sup>156</sup> Similarly, the Exchange will also use automated monitoring systems to review, in real time, the Matching System’s handling of test IOC orders to determine whether, and within what time frame: (1) IOC orders are executed against the displayed quote, up to its full size; (2) any unexecuted portion of the IOC order is cancelled; (3) a confirmation of the action taken is generated and transmitted from the Matching System to the monitoring system (to serve as a proxy for a transmission to the order-sending firm); and (4) the Matching System transmits a new bid or offer (as appropriate) to the monitoring system (to serve as a proxy for a transmission to the appropriate securities information processor).<sup>157</sup> The Exchange’s rules provide that it would automatically and immediately append a “manual” identifier to the bids and offers it makes publicly available when it has reason to believe that it is not capable of displaying automated quotations.

The Exchange has proposed a rule that renders an inbound round-lot order ineligible for execution on the Exchange if such order would cause an improper trade-through under Rule 611 of Regulation NMS.<sup>158</sup> The Commission also notes that the proposed rules provide procedures that the Exchange will follow to determine whether a trade would create an improper trade-through and how the Exchange will apply various exceptions to Rule 611 of Regulation NMS, including the self-help exception.<sup>159</sup>

F. Other Rule Changes

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<sup>156</sup> See proposed CHX Article 20, Rule 5, Interpretation and Policy .02.

<sup>157</sup> See proposed Article 20, Rule 5, Interpretation and Policy .02.

<sup>158</sup> See proposed Article 20, Rule 5(a).

<sup>159</sup> See supra notes 51-53 and accompanying text.

In addition to the rules described in detail above, the proposed rule change would adopt or amend a number of other Exchange rules that address, among other things, hours of trading, trading halts, cancelling transactions, trading permits, sponsored access, limitations of liability, trade execution, Exchange registration, business conduct, fingerprinting, reporting transactions, riskless principal transactions, disciplinary matters and trial proceedings, arbitration, books and records, clearance and settlement, and listing on the exchange. The Commission believes that these rules are appropriate and consistent with the Act, and many are similar to rules previously approved by the Commission at other exchanges.<sup>160</sup>

The Commission believes that the Exchange's proposed interpretation to its trading ahead rule in CHX Article 9, Rule 17, confirming that a participant would be deemed to be holding an unexecuted customer order when that order has been sent to the Matching System but remains unexecuted,<sup>161</sup> is consistent with the Act. The Commission believes that this rule appropriately confirms that a participant will remain the agent for any customer orders that it submits to the Matching System, and as such, will owe fiduciary duties to such customer orders until they are executed.

The Commission also believes that the proposed interpretation confirming that a participant would not be in violation of CHX Article 9, Rule 17 if it satisfied bids and offers in other markets in accordance with the requirements for a "cross with satisfy order" is consistent

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<sup>160</sup> In particular, the Commission believes that the proposed changes to the firm's supervision rules are appropriate and consistent with the Act. See proposed CHX Article 6, Rule 5. The Commission believes that these rules should help to ensure that participant firms are adequately supervising their registered and associated persons. The Commission also notes that these obligations are similar to those required by other SROs. See, e.g., NASD Rule 3010 and Philadelphia Stock Exchange Rule 748.

<sup>161</sup> See proposed CHX Article 9, Rule 17, Interpretation and Policy .05.

with the Act.<sup>162</sup> The Commission notes that the conditions of the cross with size order provide that a participant could only satisfy bids or offers in other markets at a price that is better than the cross price if the cross is for at least 10,000 shares or has a value of at least \$200,000 (a “block size order”) or is for the account of an institutional customer and the participant’s customer has specifically agreed to that outcome.<sup>163</sup>

#### IV. Accelerated Approval of Amendment No. 2

Under Section 19(b)(2) of the Act,<sup>164</sup> the Commission may not approve any proposed rule change prior to the thirtieth day after the date of publication of notice thereof, unless the Commission finds good cause for so doing. As set forth below, the Commission finds good cause to approve Amendment No. 2 to the proposed rule change prior to the thirtieth day after Amendment No. 2 is published for comment in the Federal Register pursuant to Section 19(b)(2) of the Act.<sup>165</sup>

The modification made by Amendment No. 2 to require a cross with size to be larger than the aggregate size of all orders in the Matching System at the same price, rather than larger only than the largest individual order,<sup>166</sup> merely retains – for the time being – a condition for cross with size orders that exists in the Exchange’s current rules.<sup>167</sup> The new provision to execute various types of cross orders as crosses with size if they qualify as such<sup>168</sup> simply builds in a

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<sup>162</sup> See proposed CHX Article 9, Rule 17, Interpretation and Policy .06.

<sup>163</sup> See supra note 20 (discussing cross with satisfy orders).

<sup>164</sup> 15 U.S.C. 78s(b)(2).

<sup>165</sup> Id.

<sup>166</sup> See supra note 81.

<sup>167</sup> See current CHX Article XXA, Rule 2(c)(4).

<sup>168</sup> See supra note 82.

directive into cross orders generally that enables them to receive a better execution if they meet the relevant requirements.

The revision made by Amendment No. 2 regarding cancellation of certain sell short orders improves the proposal by accounting for situations in which an appropriate price cannot be determined for an order of this type.<sup>169</sup> The addition of the “ISO Cross” order type makes explicit that a cross order, like other orders, may be appended with ISO instructions.<sup>170</sup> The revision regarding new display instructions<sup>171</sup> changes only the method by which such an instruction would need to be submitted, but alters no principle of priority included in the original proposal.

Amendment No. 2 also improves the proposal by confirming the circumstances in which the Matching System would display quotes that would lock or cross the protected quotes of other markets,<sup>172</sup> and appropriately spells out that the Matching System will trade in increments supported by the ITS or Regulation NMS linkage plan, as may be applicable.<sup>173</sup> Another provision adds clarity to how orders should be identified, according to the proposed rules, when a trade is executed pursuant to both the intermarket sweep order exception of Rule 611(b)(5) or (6) of Regulation NMS and the self-help exception of Rule 611(b)(1) of Regulation NMS.<sup>174</sup> Other clarifying changes similarly enhance the proposal.<sup>175</sup>

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<sup>169</sup> See supra note 83.

<sup>170</sup> See supra note 84.

<sup>171</sup> See supra note 86.

<sup>172</sup> See supra note 87.

<sup>173</sup> See supra, note 88.

<sup>174</sup> See supra note 89.

<sup>175</sup> See supra notes 90-95 and accompanying text.

Amendment No. 2 also incorporates a number of added restrictions and requirements for market makers that set forth in more detail the parameters by which market making may take place on the Exchange and should aid in the prevention of abuses.<sup>176</sup> In addition, Amendment No. 2 sets forth provisions requiring the Exchange to maintain internal controls designed to restrict the flow of confidential and proprietary information between the Exchange and the third-party broker-dealer providing connectivity to other markets. The provision added by Amendment No. 2 to permit “qualified contingent trades” to be executed on the Exchange<sup>177</sup> merely assures that market participants would be able to benefit from the Commission’s order exempting from Rule 611(a) any trade-throughs caused by such trades. The revisions to the text to reflect and conform to recent changes made as the result of other, recently approved CHX proposals,<sup>178</sup> as well as the technical changes and corrections included in Amendment No. 2, raise no substantive issues. Finally, a number of the changes mirror rules that already have been approved for other exchanges.

For the above reasons, the Commission believes that the revisions to the proposed rule change made by Amendment No. 2 pose no significant regulatory concerns, and should not delay implementation of the proposal. The Commission also believes that accelerated approval is reasonable because it should help to ensure that the appropriate rules are in place at the Exchange at the time that the CHX’s final technical specifications with respect to Regulation NMS must be published.

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<sup>176</sup> See supra notes 96-97 and accompanying text.

<sup>177</sup> See supra notes 97-99 and accompanying text.

<sup>178</sup> See supra note 101.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2 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-CHX-2006-05 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 Number SR-CHX-2006-05. 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 in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of 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-2006-05 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>179</sup> that the proposed rule change (File No. SR-CHX-2006-05), as amended by Amendment No. 1, be, and hereby is, approved, and that Amendment No. 2 to the proposed rule change be, and hereby is, approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>180</sup>

Nancy M. Morris  
Secretary

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<sup>179</sup> 15 U.S.C. 78s(b)(2).

<sup>180</sup> 17 CFR 200.30-3(a)(12).