

# The Chicago Stock Exchange

David A. Herron  
Chief Executive Officer



February 26, 2004

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Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549-0609

Re: File No. S7-05-04

Dear Mr. Katz:

The Chicago Stock Exchange (the "CHX" or the "Exchange") welcomes the opportunity to provide the Securities and Exchange Commission ("Commission" or "SEC") with its comments on proposed Rule 31, which sets out new procedures for the collection of data that form the basis for the Section 31 fees paid by national securities exchanges and other self-regulatory organizations ("SROs"). The Exchange understands the Commission's desire to implement a more defined process for the collection of this data and, in general, agrees with the Commission's proposal to use clearing data for that purpose. As described below, however, the Exchange also believes that the Commission should consider several other factors when setting out a new rule – such as the impact of the proposal on inter-market transactions – and should implement the proposal on a prospective, not retroactive, basis.

**1. In general terms, the CHX believes that it is appropriate for the SEC to rely on clearing data to determine the appropriate Section 31(a) fees owed by the Exchange.**

The Exchange sends records of all transactions that occur on the Exchange to the National Securities Clearing Corporation ("NSCC"). The vast majority of these records, which include regular-way trades and trades that settle on T+1 or T+2, are handled through NSCC's Continuous Net Settlement ("CNS") process. Other records – relating to trades that require cash settlement or settlement after T+3 – are currently sent to NSCC, but are not incorporated by NSCC into its clearing systems.<sup>1</sup>

The Exchange, however, also sends trades to clearing that do not occur on the Exchange. For example, if a CHX floor broker, who is also a member of NASD, effects a trade in a security that is not listed on CHX or traded pursuant to unlisted trading privileges on CHX, the floor

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<sup>1</sup> The Exchange understands that NSCC is working to incorporate these "ex-clearing" transactions into its systems.

broker can report the trade to NASD (for transaction reporting, but not clearing, purposes) and use CHX systems to report the trade to clearing. Proposed Rule 31 seems to confirm that the CHX will not be assessed the Section 31 fee associated with these transactions, because it is not the market on which the trade occurred; as further described below, the Exchange, however, will need to work with NSCC to specifically mark these transactions so that they do not appear in the NSCC report as fee-eligible.

**2. The Exchange believes that it is appropriate to adopt a de minimis exemption for ex-clearing transactions.**

As noted above, the Exchange currently sends to NSCC a report of each transaction that occurs on the Exchange. Some of these reports, however, currently are not incorporated into NSCC's systems. The Exchange does not make many of these "ex-clearing" reports – in fact, within the past 30 days, the Exchange has sent an average of five ex-clearing reports to NSCC each day, with an average daily value of \$16.5 million. Until these reports can be incorporated into NSCC's automated systems – and included in the reports that NSCC will, in turn, submit to each SRO – the Exchange encourages the Commission to adopt a de minimis exemption from proposed Rule 31 for these transactions. Once these transactions are incorporated in the automated NSCC reports, however, the Exchange believes that they should be included in the reports prepared by each SRO and sent to the Commission.

**3. The Commission should incorporate into Rule 31 an appropriate practice for determining which market is assessed Section 31 fees on intermarket transactions.**

In a single trading day, members of one market might seek executions in two, three or more other markets, through a variety of different linkages. For example, a CHX member might seek an execution on the American Stock Exchange over the Intermarket Trading System ("ITS") or on the New York Stock Exchange through the NYSE's DOT system. Alternatively, a CHX member might reach out to find liquidity in Nasdaq's SuperMontage system or in an electronic communications network ("ECN"). Because transactions in these different venues are sent to clearing in somewhat different ways and because many market centers have different arrangements associated with the re-billing of Section 31 fees to the actual sellers of securities, the CHX believes that it is important for the Commission to specifically address these issues in its proposed Rule 31.

One prominent example arises in the context of ITS transactions. When a member of SRO A sends an ITS commitment to a member of SRO B to sell stock, and the commitment is executed on SRO B, three clearing reports are sent to NSCC – (1) a report from SRO A that shows a sale of stock by an SRO A member from the SRO A/ITS omnibus account; (2) a report from SRO B that shows a purchase of stock by the SRO B member to the SRO B/ITS omnibus account; and (3) a report from ICC that shows a sale of stock by the SRO A/ITS omnibus account to the SRO B/ITS omnibus account. Proposed Rule 31 might be read to suggest that

SRO B should pay the fee on the transaction – because it occurred on SRO B – but that outcome is not consistent with current practice.<sup>2</sup> The CHX believes that the proposed rule should specifically address both the ITS situation and any other similar circumstances to provide guidance about how information should be reported about these transactions.<sup>3</sup>

**4. Proposed Rule 31 should incorporate an exception to permit exchanges to identify transactions as “riskless principal” transactions, which should not be assessed a Section 31 fee.**

In general terms, under the proposed rule, national securities exchanges would be required to pay Section 31 fees based on the trades that are sent to clearing; national securities associations would be required to pay Section 31 fees based on trades that are reported to the tape. This difference in fee assessment, while appropriate for other reasons, might result in an unintended impact on an exchange that is considering the implementation of a riskless principal trade reporting rule. The CHX thus encourages the Commission to incorporate an exception to the proposed rule that permits exchanges to identify, through their clearing systems, certain “riskless principal” transactions on which a Section 31 fee should not be assessed.

Like other markets, the Exchange has been working to develop an appropriate practice for the reporting of transactions (and the payment of Section 31 fees) where a CHX member fills a customer order based on an execution received in other markets. Today, this situation results in two transaction reports – one in the away market (between a member of that market and the CHX member) and one in the CHX market (between the CHX member and its customer). Both of these transactions must be reported to clearing; as a result, the proposed rule would require both markets to pay a Section 31 fee on those transactions. If the CHX adopts a rule under which the second leg of the transaction is considered “riskless” and therefore not a transaction

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<sup>2</sup> Although Section 31 requires various market centers to pay to the Commission the fees associated with sales of securities within their markets, the Exchange believes that most markets re-bill those fees to their member firms. In the example set out above, SRO B does not have the ability to require SRO A members to reimburse it for the costs of Section 31 fees. Therefore, SRO A typically pays the Section 31 fee associated with the ITS transaction and re-bills that amount to its member firm. These arrangements, which the Exchange believes are used by most ITS markets, are appropriate because they both ensure that the appropriate level of fees are paid and allow the market that pays the fees to re-bill those fees to its members.

<sup>3</sup>As Commission staff are aware, the CHX has a similar arrangement in place with Nasdaq with respect to CHX member participation in SuperMontage. Under this arrangement, the CHX pays the Section 31 fee whenever a CHX member is on the sell side of a transaction in SuperMontage and rebills that fee to its member.

Other intermarket transactions that should be addressed in the proposed rule are those involving ECNs and non-NASD members. The Exchange believes that, in most instances, the Section 31 fees on these transactions could be paid by the SRO that reports the transaction to the tape because exchange members only transact business on ECNs when they have a separate relationship with the ECN. Under the terms of that separate relationship – whether it is a trading permit or other right of participation – the ECN can rebill the Section 31 fee to the exchange member.

that should be reported to the tape, the Exchange would want to be sure that this transaction is not one on which Section 31 fees are assessed.<sup>4</sup> The Exchange thus encourages the Commission to incorporate an exemption in proposed Rule 31 to address those situations.

**5. Proposed Rule 31 should not have retroactive effect; instead, it should be applied to transactions on a prospective basis only, to allow NSCC and market centers to adapt their systems to the new procedures.**

The Commission proposes to have Rule 31 take effect retroactively, to cover transactions that occurred from September 1, 2003 through the present. The CHX believes that retroactive application of the rule will cause unnecessary work for SROs and for NSCC, at a time when resources can and should be spent on other issues.

As an initial matter, if the proposed rule has retroactive effect, SROs will be required to review, all at once, many months of NSCC-provided data to determine whether or not the data correctly captures all of the information that should be reported to the Commission. By raising this point, the CHX does not intend to suggest that NSCC will make mistakes in compiling its data; most data gathering and reporting projects, however, involve detailed analysis and programming and, despite a group's best attempts, can incorporate unintended errors. The CHX believes that this initial review of the first batch of NSCC-provided reports can be more easily accomplished on a prospective basis, where an SRO is only looking at one month's data to determine its accuracy.

Moreover, SROs should be given time to integrate the NSCC-provided data into their billing systems to ensure that they correctly re-bill those fees to their member firms. The CHX believes that this project can best be done on a prospective basis. Since September 2003 – the proposed retroactive starting point for the proposed rule – the CHX has been billing its members Section 31 fees based on the data in its systems. If there are differences between the NSCC reports and the data used by the CHX in its billing, the CHX will be required to reconcile the two sets of data, on a trade-by-trade basis. The CHX cannot estimate the time associated with this project, because it has not yet seen the reports that NSCC will prepare. Prospective application of the proposed rule, however, will avoid the need for the CHX, or any other SRO, to dedicate resources to this task.

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<sup>4</sup>The Exchange has been working to develop such a rule based, in large part, on the riskless principal trade reporting rules in place for NASD members. At the suggestion of Commission staff, the Exchange decided in January to postpone its submission of a proposed rule because of the Commission's plans to issue the current proposal. The Exchange is now working again on its proposed rule and anticipates discussing it with Commission staff in upcoming weeks.

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Finally, the CHX is not confident that NSCC reports for prior months can accurately back out the transactions that the CHX sends to clearing, but which do not occur on the CHX.<sup>5</sup> These transactions, as noted above, should not be assessed a Section 31 fee, but were included in the Exchange's clearing records.

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The Exchange appreciates the opportunity to share its thoughts with the Commission on these topics. If you have any questions about these comments, please do not hesitate to call me at the number listed above, or Ellen Neely, the Exchange's general counsel, at 312/663-2496.

Very truly yours,

A handwritten signature in black ink, appearing to read "David A. Herron", with a long horizontal flourish extending to the right.

David A. Herron

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<sup>5</sup> These transactions were not flagged in any particular way when they were submitted to NSCC, so that the CHX and NSCC would need to work together to try to determine whether there is a way to retrofit an automated mechanism for identifying the trades. If there is not an automated way to do so, the CHX would be unfairly required to pay fees on trades that occurred in other markets.