

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53772; File No. SR-CHX-2004-38)

May 8, 2006

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Amendment Nos. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 3 and 4 Thereto Relating to Records of Orders and Executions

I. Introduction

On November 3, 2004, the Chicago Stock Exchange, Inc. (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend CHX Article XX, Rule 24 to require on-floor participants to electronically record specific details about orders originating on or off the floor of the Exchange for execution on the Exchange, as well as orders issued from the floor of the Exchange to any other market or trading venue. On July 3, 2005 and September 8, 2005, the Exchange filed Amendment Nos. 1³ and 2⁴ to the proposed rule change, respectively. The proposed rule change, as amended by Amendment Nos. 1 and 2, was published for comment in the Federal Register on November 18, 2005.⁵ The Commission received no comments on the proposal, as amended by Amendment Nos. 1 and 2. On December 13, 2005, the CHX filed Amendment No. 3 to the proposed rule

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Amendment No. 1 dated July 3, 2005.

⁴ See Amendment No. 2 dated September 8, 2005.

⁵ See Securities Exchange Act Release No. 52766 (November 10, 2005), 70 FR 70002 (“Notice”).

change.⁶ On May 3, 2006, the CHX filed Amendment No. 4 to the proposed rule change.⁷ This order approves the proposed rule change, as amended by Amendment Nos. 1 and 2; grants accelerated approval to Amendment Nos. 3 and 4 to the proposed rule change; and solicits comments from interested persons on Amendment Nos. 3 and 4.

⁶ See Amendment No. 3 dated December 12, 2005. Amendment No. 3 clarified that while the Exchange's systems are the only systems currently recognized by the Exchange for the collection and recording of the required information, Exchange participants ultimately could develop their own systems for collecting and recording that information so long as the systems provide the data in a format acceptable to the Exchange; the Brokerplex® system is available to all floor participants who request the system and pay any applicable fees; and the Exchange is making changes to its existing Brokerplex® system to permit this proposal to be implemented. Brokerplex® is the Exchange's floor broker order management system that can be used by CHX floor brokers to manage their orders, route orders to the Exchange's co-specialists for execution, and report executed trades. It is not an order execution system, although it can send orders to the CHX's MAX® system. See infra note 15 (describing the MAX® system). The Commission notes that the Exchange does not currently impose a separate fee for use of the Brokerplex® system, and to the extent that the Exchange ever contemplates imposing such a fee it would need to file a rule change with the Commission under Section 19(b) of the Act and Rule 19(b)(4) thereunder.

⁷ See Amendment No. 4 dated May 3, 2006. In addition to clarifying changes to the rule text, Amendment No. 4 adds Interpretation and Policy .10 to the proposed rule to specify a compliance date of May 8, 2006 by which the Exchange's on-floor participants must comply with the rule. In addition, Amendment No. 4 confirms that the Exchange's systems will permit a floor broker, when identifying the side of the market on which an order is received, to attach a special designation to a cross order (which will be attached to the side of the market designation in field (b)(6)) when, on account of the customer's instructions and to the extent permitted by the Exchange's rules, that order cannot be immediately executed. Amendment No. 4 also clarifies Interpretation and Policy .02 to specify that records must be kept pursuant to the proposed rule change for orders delivered orally or telephonically to a specialist at the post. Finally, in Amendment No. 4, the Exchange represented that (1) it will notify its participants that they should notify the Exchange if they believe that an Exchange system does not permit them to enter all of the information required by the proposed rule, as permitted by Interpretation and Policy .05; (2) it will consider further changes to CHX Rule 24 in response to changes to Commission or Exchange rules; and (3) it believes that with respect to immediately executed orders, it receives all of the information necessary to conduct surveillance through the information required under Interpretation and Policy .07 and other Exchange systems.

II. Description of the Proposal

Under the proposed rule change, the Exchange proposes to require its floor participants to provide particular data about all orders originating on or off the floor of the Exchange for execution on the Exchange, as well as all orders issued from the floor of the Exchange to any other market or trading venue.⁸ Specifically, the Exchange proposes to require floor participants to record, in electronic systems designated by the Exchange, the following details about each covered order: (1) the symbol of the security; (2) the clearing participant; (3) an order identifier that uniquely identifies the order;⁹ (4) the identity of the participant recording the order details; (5) the number of shares or quantity of the security; (6) the side of the market; (7) a designation of the order type (e.g., market, limit, stop, stop limit); (8) whether the order is agency or professional;¹⁰ (9) whether the order is being handled pursuant to Section 11(a)(1)(G) of the Act and any applicable rules thereunder; (10) whether the order is short or short exempt; (11)

⁸ The Exchange represents that this proposal is consistent with recommendations made by the independent consultant retained by the Exchange under its recent settlement agreement with the Commission. See Securities Exchange Act Release No. 48566 (September 30, 2003), Administrative Proceeding File No. 3-11282. See also Notice, supra note 5, at note 13.

The Commission notes that the Exchange recently amended CHX Article V, Rule 4 to prohibit Exchange participants from using any communications means to send orders to another market for execution (“layoff service”), unless that layoff service has established a process for providing the Exchange with specific information about the orders and the executions that participants receive. See Securities Exchange Act Release No. 52534 (September 29, 2005), 70 FR 58500 (October 6, 2005) (SR-CHX-2004-25). In addition, the Exchange has represented that the Exchange’s staff will present to the Exchange’s Board of Directors a separate rule that confirms the record-keeping obligations of its off-floor participants. See Notice, supra note 5, at note 16.

⁹ This order identifier does not change when modifications are made to the order, or when it is cancelled, allowing any changes to be tracked back to the original order.

¹⁰ The Exchange’s rules define a “professional” order as one that is for the account of a broker-dealer, the account of an associated person of a broker-dealer, or any account in which a broker-dealer or an associated person of a broker-dealer has any direct or indirect interest. See CHX Article XXX, Rule 2, Interpretation and Policy .04.

whether the order is a bona fide arbitrage order; (12) any limit price and/or stop price; (13) the date and time of order receipt or transmission (as applicable); (14) the market, off-floor firm, or on-floor participant to which the order was transmitted or from which the order was received (if applicable); (15) the order's time in force; (16) designation as held or not held; (17) any special conditions or instructions (e.g., any customer display or do-not-display instructions or any all-or-none conditions); (18) any modifications that are made to the details set out in (1) through (17) above or (20) below, for all or part of the order, or any cancellation of all or part of the order; (19) the date and time of receipt or transmission of any modifications to, or cancellation of, the order; (20) the date and time of any order expiration; (21) the identity of the party cancelling or modifying the order; (22) the transaction price, if applicable; (23) the number of shares executed, if applicable; (24) the date and time of execution, if applicable; (25) the contra party to the execution (if applicable); (26) the settlement instructions associated with the order, if applicable; (27) system-generated time(s) of recording required information; and (28) any other information that may be required by the Exchange from time to time.¹¹ Floor participants would be required to record this information immediately after that information is received or becomes available.¹²

In addition, proposed new Interpretations and Policies .01 to .09 to CHX Article XX, Rule 24 contain additional guidance on the information that participants would be required to record and preserve. Among other things, the interpretations establish the scope of the proposed rule and specify the exclusion from the proposed rule for principal trading by a co-specialist, market maker, or floor broker.¹³ In addition, the interpretations note that participants will not be

¹¹ See CHX Article XX, Proposed Rule 24(b).

¹² See CHX Article XX, Proposed Rule 24(c).

¹³ See CHX Article XX, Proposed Rule 24, Interpretation and Policy .02; and Amendment No. 4, supra note 7 (Interpretation and Policy .02 states that "Except for orders delivered orally or telephonically to a specialist at the post, a decision by a co-specialist, market

required to record information with respect to orders sent or received through the Exchange's MAX® system¹⁴ or through any other electronic systems that the Exchange recognizes as providing the required information in an acceptable format, and further sets out limited exceptions to the data-recording requirements.¹⁵

III. Discussion and Commission Findings

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.¹⁶ In particular, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,¹⁷ which requires that the rules of an exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

maker or floor broker to buy or sell securities for his or her own account on the Floor of the Exchange shall not constitute an order for which a record much be made under this Rule.”). The Exchange has represented that this exception is designed to recognize that all necessary information about a floor participant’s own trading is already captured by the Exchange’s reporting systems. See Notice, supra note 5, at note 11.

¹⁴ MAX® is the Exchange’s electronic execution system.

¹⁵ See Proposed Interpretations and Policies .04 (regarding orders sent and received through certain systems), .05 (regarding orders that the Exchange expressly recognizes as incompatible for entry into an Exchange system), .06 (regarding bona fide arbitrage orders and orders to offset a transaction made in error); and .07 (regarding cross orders that are immediately executed). Proposed Interpretation and Policy .09, however, reminds participants that the provisions of proposed CHX Rule 24 do not replace any record retention obligations to which a participant may be subject under the Act.

¹⁶ In approving this proposed rule change, as amended, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁷ 15 U.S.C. 78f(b)(5).

The purpose of the Exchange's proposed rule change is to require the Exchange's floor participants to enter order-related information into an electronic data capture system to facilitate automated surveillance of market activity by the Exchange.¹⁸ For example, CHX floor brokers have traditionally accepted orders from a variety of sources, some of which may not involve the creation of an electronic audit trail (e.g., orders taken over the telephone). In these cases, only the execution information would be captured electronically, and thus be able to be searched in an electronic form by the Exchange's market regulation personnel. Non-execution information relating to the original order (e.g., time of order receipt) is available currently only from the paper order ticket. By requiring the electronic capture of this information, the Exchange would be able to use the data obtained from the proposed rule change in surveillance reports relating to, for example, best execution, front-running surveillance, order execution priority, manipulative activity, and trade reporting.

Further, the Exchange's proposed rule change is intended to address recommendations made in the Exchange's 2003 settlement agreement with the Commission.¹⁹ In the settlement agreement, the Commission cited the Exchange's failure, with respect to its specialist firms, "to detect and prevent a large number of trading rule violations, in part, because [the Exchange] did not have adequate surveillance systems to detect possible violations."²⁰ In addition, the Commission found that the CHX had "relied on ineffective and often flawed manual processes to

¹⁸ See Letter from David C. Whitcomb, Jr., Senior Vice President and Chief Regulatory Officer, CHX, to Sharon Lawson, Senior Special Counsel, Division of Market Regulation, Commission, dated June 27, 2005.

¹⁹ See Securities Exchange Act Release No. 48566 (September 30, 2003) (Administrative Proceeding File No. 3-11282), available at: <http://www.sec.gov/litigation/admin/34-48566.htm>.

²⁰ Id.

detect violations....”²¹ Pursuant to the settlement agreement, the Exchange undertook to engage a consultant to conduct a comprehensive review of, among other things, its trading floor surveillance to ascertain whether its trading floor surveillance is appropriately designed and implemented to promote and enforce compliance with the federal securities laws and CHX and Commission rules.

The Commission believes that the Exchange’s proposed rule change, as amended, to require Exchange participants to enter order-related information into an electronic data capture system is consistent with the Exchange’s settlement agreement with the Commission. Specifically, the Commission believes that the proposed rule change, as amended, should allow the Exchange to maintain a more automated process for receiving a comprehensive set of audit trail data on its floor participants’ trading activity and thereby allow the Exchange to integrate more audit trail data into its surveillance systems. Increased automation with respect to the receipt of order details should, in turn, allow the Exchange to perform more automated surveillance and generate better surveillance reports. In addition, the Commission believes that the proposal will improve the Exchange’s ability to review its participants’ order-handling activities and to determine their compliance with applicable trading rules, including, for example, short sale position marking and tick test requirements,²² best execution,²³ and trading ahead prohibitions.²⁴

Further, the Commission notes that proposed Interpretation and Policy .05, which would allow the Exchange to identify specific types of orders that might be exempt from the data-

²¹ Id.

²² See 17 CFR 240.10a-1.

²³ See, e.g., CHX Article XX, Rule 10.

²⁴ See CHX Article XXX, Rules 2 and 3.

recording requirements when they are incompatible for entry into Exchange systems, is designed to cover only those rare situations where, due to unexpected consequences of unrelated systems changes or a software failure, CHX participants cannot enter data about a particular type of order into the Exchange's systems for a limited period of time. The Commission notes that this exception is not intended to allow participants to avoid the recording requirements of the rule, and does not relieve a participant from its record-keeping obligations under the Exchange's rules and applicable federal securities laws. The Commission notes that the Exchange has represented that it would work with participants to correct quickly any software or systems problems that precipitated the system incompatibility.²⁵ Furthermore, the Exchange will notify its participants that the participants should notify Exchange personnel when a system incompatibility arises that is covered by proposed Interpretation and Policy .05.²⁶

With respect to proposed Interpretation and Policy .04, which recognizes that participants are not required to record information that is already captured by the Exchange's systems or by other systems that the Exchange expressly recognizes as providing the required data in an acceptable format, the Commission notes that the Exchange has represented that its MAX® system already captures all of the information required by the proposed rule change.²⁷ The Commission also notes that the Exchange has represented that it retains records associated with its MAX® system for the applicable record retention period.

With respect to proposed Interpretation and Policy .07, which permits a participant to record only certain information for orders to buy and sell the same security that are executed in full immediately upon receipt, the Commission notes that the Exchange has represented that

²⁵ See Notice, supra note 5, at note 14.

²⁶ See Amendment No. 4, supra note 7.

²⁷ See Notice, supra note 5, at note 14.

Interpretation and Policy .07 to the proposed rule change reflects the Exchange's belief that it will receive all of the information necessary to conduct surveillance with respect to orders to buy and sell the same security that are executed in full immediately upon receipt through a combination of Interpretation and Policy .07 and other information captured within the Exchange's system.²⁸ In particular, the Commission notes that the Exchange's order management systems utilize an account-based approach in which principal transactions are entered through a principal trading account that is separate from the broker's agency account, and that the Exchange's surveillance reports are able to distinguish between a broker's principal and agency trades.²⁹ Further, the Exchange has the ability to request information from its clearing participants in the event that the Exchange requires information about the customers involved in a certain transaction where a customer did not serve as the clearing participant to its own order.³⁰

Based on the above, the Commission finds that the Exchange's proposed rule change is consistent with the Exchange's settlement agreement with the Commission.³¹ Further, the Commission finds that the Exchange's proposal to require the electronic capture of audit trail data in order to enhance surveillance for compliance with CHX's rules, the Act, and the rules thereunder is consistent with the requirements of Section 6(b)(5) of the Act,³² which requires that

²⁸ See Amendment No. 4, *supra* note 7.

²⁹ See Letter from David C. Whitcomb, Jr., Senior Vice President and Chief Regulatory Officer, CHX, to Sharon Lawson, Senior Special Counsel, Division of Market Regulation, Commission, dated April 26, 2006.

³⁰ Telephone conversation between Ellen J. Neely, President and General Counsel, CHX, and Richard Holley III, Special Counsel, Division of Market Regulation, Commission, on May 3, 2006.

³¹ See *supra* note 19.

³² 15 U.S.C. 78f(b)(5).

the rules of an exchange be designed to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The Commission believes that approving the proposal will help to enhance and strengthen the Exchange's surveillance program by providing the Exchange with the data necessary to conduct more thorough and efficient surveillance of its participants' trading activities, and should thereby promote just and equitable principles of trade and further the protection of investors and the public interest. The Commission notes that the detailed information required to be obtained will not replace any record retention obligations already required of CHX participants under the Act and the rules thereunder.

Accelerated Approval of Amendment Nos. 3 and 4

The Commission finds good cause for approving Amendment Nos. 3 and 4 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the Federal Register pursuant to Section 19(b)(2) of the Act.³³ In Amendment No. 3, the Exchange merely clarified that (1) participants could develop their own systems for collecting and recording required data in a format acceptable to the Exchange; (2) Brokerplex® is available to any participant; and (3) the Exchange is implementing changes to the Brokerplex® system to incorporate the requirements of this proposed rule change. In Amendment No. 4, the Exchange merely modified its proposed rule change to accommodate an order designation currently used by its floor brokers that permits a floor broker to attach a special designation to a cross order when, on account of the customer's instructions and to the extent permitted by the Exchange's rules, the cross order cannot be immediately executed, as well as set May 8, 2006 as the compliance date.³⁴ In addition, the Exchange made, in part, certain clarifications and

³³ 15 U.S.C. 78s(b)(2).

³⁴ The special designation would be attached to the side of the market identifier. See proposed CHX Article XX, Rule 24(b)(6). The floor broker would be required to

representations regarding the operation and implementation of the proposed rule, and the ability of the Exchange to gather sufficient surveillance information.

The Commission believes that Amendment No. 3 appropriately reflects that changes to the Brokerplex® system are being implemented in connection with the proposed rule change. In addition, the Commission believes that Amendment No. 4 implements a reasonable compliance date for the proposed rule change, as amended, since the Exchange has been holding biweekly meetings with its participants to educate them about the requirements of the proposed rule change. Furthermore, the Commission believes that the other changes made to the proposed rule change in Amendment No. 4, as described above, merely accommodate the functionality currently employed by floor brokers, acknowledge the ability of the Exchange to obtain surveillance information, clarify that records must be kept pursuant to the proposed rule for orders delivered orally or telephonically to a specialist at the post, and describe other responsibilities of the Exchange under the proposed rule change, as amended. Accordingly, the Commission believes that good cause exists, consistent with Section 19(b) and Section 6(b)(5) of the Act, to accelerate approval of Amendment Nos. 3 and 4 in order to allow the Exchange to implement the proposal immediately.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment Nos. 3 and 4 to the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

complete all other fields required by proposed CHX Article XX, Rule 24. In addition, this special designation does not alter a participant's obligations with respect to the execution of orders; if a cross transaction can be immediately executed in accordance with a customer's instructions and applicable rules, it should be immediately executed. See Amendment No. 4, supra note 7.

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CHX-2004-38 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CHX-2004-38. 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 such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CHX-2004-38 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

For the foregoing reasons, 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.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁵ that the proposed rule change (SR-CHX-2004-38) and Amendment Nos. 1 and 2 thereto are approved, and that Amendment Nos. 3 and 4 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁶

Nancy M. Morris
Secretary

³⁵ 15 U.S.C. 78s(b)(2).

³⁶ 17 CFR 200.30-3(a)(12).