

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54301; File No. SR-CHX-2006-05)

August 10, 2006

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

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> notice is hereby given that on February 2, 2006, the Chicago Stock Exchange, Inc. (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the CHX. On August 10, 2006, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The CHX proposes to amend its rules to implement a new trading model that provides the opportunity for entirely automated executions to occur within a central matching system accessible by all Exchange participants. The new model also would end the Exchange’s operation of a physical trading floor and is intended to comply with the requirements of Regulation NMS (“Reg. NMS”).<sup>4</sup> The text of this proposed rule change is available on the Exchange’s Web site at [http://www.chx.com/rules/proposed\\_rules.htm](http://www.chx.com/rules/proposed_rules.htm), in the Commission’s Public Reference Room, and on the Commission’s Web site at [www.sec.gov](http://www.sec.gov).

---

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

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

<sup>3</sup> Amendment No. 1 replaces and supersedes the original filing in its entirety.

<sup>4</sup> 17 CFR 242.600, et seq.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the CHX included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CHX has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Through this proposed rule change, the Exchange seeks to implement a new trading model that allows its participants to interact in a fully-automated matching system. In this model, the Exchange would no longer operate a physical trading floor where on-floor specialists, brokers and market makers seek execution of their orders. Instead, the Exchange would operate an automated system where its participants – from any location – could submit orders for immediate execution. The Exchange believes that this new model provides an opportunity for its participants and their customers to receive efficient, low-cost executions, while giving the Exchange enhanced capabilities for surveilling its participants' trading activities.

In this new model, the Exchange anticipates that most of its participants would continue to be “off-Exchange” order-sending firms that would simply send orders to the Matching System for execution. These firms would not be required to register with the Exchange to act in any

specific capacity other than as trading participants.<sup>5</sup> The Exchange would, however, allow participant firms to register in two special categories – to operate as proprietary market makers on the Exchange or to act as institutional brokers. Market makers could choose to post two-sided quotations and trade for their proprietary accounts. Any customer order would be accepted off the Exchange and a market maker could then choose whether or not to enter the order in the Exchange’s Matching System or submit the order to a different venue. In contrast, any customer orders accepted by institutional brokers would be deemed to be on the Exchange when accepted. These market makers and institutional brokers would operate on the Exchange, even if they are not physically located on a single trading floor.

Because the Exchange is taking this opportunity to modernize many of its long-standing procedures and rules, the implementation of the new trading model will result in changes to virtually every section of the Exchange’s rule book. The most significant changes can be found in new CHX Article 20 of the Exchange’s rules, which describes the operation of the Exchange’s central matching system. CHX Article 16 details the new role of market makers on the Exchange, and CHX Article 17 describes the role and responsibilities of the Exchange’s institutional brokers. Changes to other sections of the rules are designed to eliminate obsolete provisions – including those that relate to the operation of a physical trading floor – and to update other responsibilities to reflect the more automated trading that is the hallmark of the Exchange’s new model. The Exchange has also made an effort to better organize the rules. After describing

---

<sup>5</sup> Since its demutualization in February 2005, the Exchange has not had “members.” Instead, a broker-dealer that seeks to effect transactions directly on the Exchange must become an Exchange “participant.”

the provisions of new CHX Articles 20, 16 and 17, this submission will review each of the other sets of proposed rule changes beginning with CHX Article 1.<sup>6</sup>

**a. The Matching System**

The Exchange's Matching System would be the core facility of the Exchange. It would provide the only means for the display of orders and a central point for the execution of orders. On one hand, the Matching System is simply an extension of the operation of the Exchange's electronic book to all securities traded on the Exchange.<sup>7</sup> On the other hand, this Matching System would provide a much more robust platform for the interaction of orders than is possible on the Exchange today.

1. Trading hours. The Matching System would operate a regular trading session and a late trading session each day.<sup>8</sup> The regular trading session ordinarily would begin immediately after the primary market for a security opens its market and would end at 3:00 p.m. each day for all securities except specified exchange-traded funds, which would trade until 3:15 p.m.<sup>9</sup> The second trading session – the late trading session – would begin immediately after the close of the first session and would end at 3:30 p.m.<sup>10</sup> Two senior officers of the Exchange could

---

<sup>6</sup> Throughout its rule book, the Exchange is replacing the Roman numerals currently used to identify each of its articles with an easier-to-understand Arabic number.

<sup>7</sup> See Securities Exchange Act Release No. 52094 (July 21, 2005), 70 FR 43913 (July 29, 2005) (approving the electronic book for the trading of securities not assigned to a specialist firm).

<sup>8</sup> See CHX Article 20, Rule 1(b).

<sup>9</sup> All times referenced in this filing are expressed in Central Time.

<sup>10</sup> These sessions are similar to the trading sessions that occur on the Exchange today, except that the late trading session in the new model (unlike the extended session under the current rules, in which the MAX system is not operational) would be a fully automated trading session. See CHX Article IX, Rule 10(b).

decide to open the Exchange for trading if the primary market announces that it will not open or will open later than usual, or if the primary market has not opened within 15 minutes after its normal operating time.<sup>11</sup> Special rules apply to the trading hours for securities listed exclusively on the Exchange.<sup>12</sup>

2. Access to the Matching System. Exchange participants could route orders to the Matching System through any communications line approved by the Exchange.<sup>13</sup> To the extent that the Exchange participates in the Intermarket Trading System (“ITS”) Plan or any other linkage plan, ITS commitments and other intermarket orders could be sent to the Matching System through those linkages.<sup>14</sup>

---

<sup>11</sup> See CHX Article 20, Rule 1, Interpretation and Policy .03. If these officers decide to open one or more NYSE-listed, Amex-listed or other listed securities (other than Nasdaq-listed securities) when the primary market for these securities is not trading, the Matching System will cancel all pending opening cross orders in affected securities and, at the opening time selected by these officers, will then accept all other orders and match them as provided by the Matching System rules. If these officers decide to open one or more Nasdaq-listed securities when the primary market for these securities is not trading, the Matching System will: (a) if the decision is made before 8:30 a.m., execute all opening cross orders in affected securities as if the primary market had opened and then accept all other orders and match them as provided by the Matching System rules; or (b) if the decision is made on or after 8:30 a.m., cancel all pending opening cross orders in affected securities and, at the opening time selected by the Exchange officers, then accept all other orders and match them as provided by the Matching System rules.

<sup>12</sup> See CHX Article 20, Rule 1, Interpretation and Policy .04 (confirming that the regular trading session for these securities would begin at 8:30 a.m. and end at 3:00 p.m.).

<sup>13</sup> See CHX Article 20, Rule 8(a)(1).

<sup>14</sup> See CHX Article 20, Rule 8(a)(2). So long as it is required by the OTC/UTP Plan, the Exchange would also provide telephonic access to NASD market makers. See CHX Article 20, Rule 8(a)(3).

3. Eligible orders – basic requirements. The Exchange’s Matching System would only accept day orders; orders designated good-till-canceled would not be accepted.<sup>15</sup> Similarly, except for immediate-or-cancel market orders or specially-designated cross orders, the Matching System would only accept limit orders and orders for regular-way settlement.<sup>16</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 must be submitted only in those share sizes.<sup>17</sup>

Except for any types of cross and cross with size orders (described later in this filing), the Matching System would only accept orders that comply with the sub-penny requirements of Reg. NMS set out in Rule 612<sup>18</sup> and that do not exceed any size and/or price limitations imposed by the Exchange to help eliminate erroneous transactions or orders and transactions that cannot be processed by the Exchange’s systems.<sup>19</sup> Because cross and cross with size orders essentially are sub-penny executions (rather than orders), these transactions could be submitted to the Matching System in sub-penny increments down to \$0.000001.<sup>20</sup> Importantly, however, the Matching

---

<sup>15</sup> See CHX Article 20, Rule 4(a)(2).

<sup>16</sup> See CHX Article 20, Rules 4(a)(1), 4(a)(3) and 4(a)(7). A special type of order – a non-regular way cross order – could be submitted for execution and non-regular way settlement. See CHX Article 20, Rule 4(b)(15).

<sup>17</sup> See CHX Article 20, Rule 4(a)(4).

<sup>18</sup> 17 CFR 242.612.

<sup>19</sup> See CHX Article 20, Rule 4(a)(6). The Exchange intends to develop a set of parameters that would be used to identify orders that either appear to be erroneous (based on their relationship to current market conditions) or that exceed the Exchange’s systems capabilities (such as orders priced higher than a very high dollar level or those for a very large number of shares). These orders would be rejected to permit the continued effective operation of the Matching System.

<sup>20</sup> See CHX Article 20, Rule 4(a)(7)(b), confirming that cross and cross with size orders can be submitted in sub-penny increments, whether the orders are priced less than or at or above \$1.00. The Exchange represents that it understands that it will need to obtain

System would not allow any type of cross or cross with size order (except a midpoint cross, a cross that executes at the midpoint of the NBBO or a cross with size) (i) priced at or above \$1.00, to execute at a price less than \$.01 better than any order on the same side of the Matching System, or (ii) priced under \$1.00, to execute at a price less than \$.0001 better than any order on the same side of the Matching System.<sup>21</sup>

4. Order types and conditions. The Matching System would accept a wide variety of order types and conditions, which are set out in CHX Article 20, Rule 4(b). Some of the more routine order types would include immediate or cancel (“IOC”) limit and market orders, fill or kill (“FOK”) orders, sell short and short exempt orders, reserve size orders, time in force orders and cancel on halt orders.<sup>22</sup> As required by Reg. NMS, 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.<sup>23</sup> Reserve size orders would permit a participant to identify a portion of an order to be displayed and a portion that should remain undisplayed, and to provide an instruction that the displayed portion should be refreshed to the original display quantity whenever the displayed share size falls below a specific

---

exemptive relief from the requirements of Reg. NMS to permit these executions to occur and will work with Commission staff to obtain that relief.

<sup>21</sup> See CHX Article 20, Rule 4(a)(7)(b). The Exchange represents that it has imposed this requirement based on input from Commission staff that it is required for any market operated by a national securities exchange.

<sup>22</sup> See CHX Article 20, Rule 4(b)(12) (IOC orders); Rule 4(b)(13) (IOC market orders); Rule 4(b)(11) (FOK orders); Rule 4(b)(20) (sell short orders); Rule 4(b)(21) (short exempt orders); Rule 4(b)(19) (reserve size orders); Rule 4(b)(22) (time in force orders); and Rule 4(b)(3) (cancel on halt orders).

<sup>23</sup> See CHX Article 20, Rules 4(b)(12) (IOC orders) and 4(b)(13) (IOC market orders).

threshold.<sup>24</sup> Time in force orders would be eligible for execution within a specified time period, with any unexecuted balance to be immediately cancelled when this period expires.<sup>25</sup> Cancel on halt orders would be automatically cancelled by the Matching System if a trading halt or suspension is declared on the Exchange in that security.<sup>26</sup>

The Matching System also would accept several different types of cross transactions, including a basic cross, a cross with size, a cross with satisfy, a cross with yield, a midpoint cross, an opening cross and a non-regular way cross. A basic 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, where required by the ITS Plan, another linkage plan or Reg. NMS, equal to or better than the NBBO.<sup>27</sup> A cross with size would be a cross 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, where required by the ITS Plan, another linkage plan, or Reg. NMS, equal to or better than the NBBO), where the size of the cross transaction is larger than the largest order displayed on the Exchange at that price.<sup>28</sup> A cross with satisfy is designed to provide a participant with an efficient

---

<sup>24</sup> See CHX Article 20, Rule 4(b)(19).

<sup>25</sup> See CHX Article 20, Rule 4(b)(22). The Matching System initially would permit participants to identify any time period of a minute or a multiple of a minute as the "time in force" for a particular order. In later upgrades to the Matching System, participants would be allowed to identify an order's "time in force" in seconds.

<sup>26</sup> See CHX Article 20, Rule 4(b)(3).

<sup>27</sup> See CHX Article 20, Rule 4(b)(4). A cross may represent interest of one or more Exchange participants, trading for a proprietary account. This order or transaction type is already permitted in the Exchange's electronic book. See CHX Article XXA, Rule 2.

<sup>28</sup> See CHX Article 20, Rule 4(b)(6). A cross with size is already permitted in the Exchange's electronic book and is similar to the type of transaction that can take place on the Exchange's trading floor. See CHX Article XXA, Rule 2; CHX Article XX, Rule 23. The proposed definition of a cross with size transaction would reduce the required number of shares in the order to 5,000 shares from 25,000 shares, mirroring similar

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.<sup>29</sup> A cross with yield is a similar order type, which would automatically yield interest on the buy, sell or either side of the order to

---

requirements in the floor trading rules of other markets. See Boston Stock Exchange Rules, Chapter II, Section 18; Philadelphia Stock Exchange Rule 126(h). At the same time, the definition would be changed to also require that a cross must have a value of \$100,000. The Exchange represents that it has imposed this requirement based on input from Commission staff that it is required for any market operated by a national securities exchange and based on an assurance from Commission staff that all national securities exchanges would be required to impose a similar requirement. The proposed definition of a cross with size transaction also would confirm that this order could represent interest of one or more participants of the Exchange.

<sup>29</sup> See CHX Article 20, Rule 4(b)(5). With this order type, a participant would send: (A) an instruction to execute a cross transaction at a specific price; and (B) an instruction (i) to execute orders already displayed in the Matching System at their limit prices (up to a specified number of shares) against a specified party to the extent necessary to allow the cross transaction to occur and/or (ii) to route outbound orders or commitments to other market centers to the extent necessary to prevent an improper trade-through. If a cross with satisfy is sent with a share size that is too small to satisfy orders in the Matching System or bids or offers in other markets, as applicable, the order would be automatically cancelled. Once the satisfying execution has occurred (or, for orders or commitments sent to other market centers, those orders or commitments have been sent), the cross would 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 NYSE, Amex and any exchange other than Nasdaq (and for Nasdaq-listed securities, when Reg. NMS is implemented in those issues), equal to or better than the NBBO.

A cross with satisfy may 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 would not be eligible to satisfy existing bids or offers in the Matching System at a price that is better than the cross price and 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 (as that term is defined in CHX Article 8, Rule 11, Interpretation and Policy .03) and the participant’s customer has specifically agreed to that outcome.

any order already displayed in the Matching System at the same or better price.<sup>30</sup> And, finally, as their names suggest, an opening cross is a cross transaction that would be specifically designated to be executed at the opening price; a non-regular way cross would be designated for non-regular way settlement; and a midpoint cross would execute at the midpoint between the NBBO.<sup>31</sup>

---

<sup>30</sup> See CHX Article 20, Rule 4(b)(7). This order would have: (A) an instruction to execute a cross transaction at a specific price; and (B) 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. The cross would 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 NYSE, Amex and any exchange other than Nasdaq (and for Nasdaq-listed securities, when Reg. NMS is implemented in those issues), equal to or better than the NBBO.

<sup>31</sup> See CHX Article 20, Rule 4(b)(16) (opening cross); Rule 4(b)(15) (non-regular way cross); and Rule 4(b)(14) (midpoint cross). As described later in this submission, 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. Opening cross orders would not be accepted in securities exclusively listed on the Exchange and would not be accepted if any part of the sell side of the order is marked as a sell short order. A midpoint cross would be executed at the midpoint of the NBBO, but 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.

A non-regular way settlement cross would execute without regard to the NBBO or any other orders the Matching System and could represent the interest of one or more participants in the Exchange. Any non-regular way cross that is for cash settlement must be received by the Matching System by 2:00 p.m. or such other time that may be established by the Exchange and communicated to participants from time to time. The Matching System would not accept one-sided orders for non-regular way settlement. The only way to effect a non-regular way transaction within the Matching System would be through a non-regular way cross. Exchange participants currently may execute orders for non-regular way settlement, both on the floor of the Exchange and in the Exchange's electronic book. See CHX Article XX, Rule 9; CHX Article XXA, Rule 2(c)(5).

The Matching System also would accept several order types that are specifically contemplated by Reg. NMS.<sup>32</sup> For example, the Matching System would accept benchmark orders which meet the requirements of Rule 611(b)(7) of Reg. NMS. Initially, the Exchange would limit submission of benchmark orders to the Exchange's institutional brokers.<sup>33</sup> The Matching System would also accept BBO intermarket sweep orders ("BBO ISOs"), which would execute against orders at the Exchange's BBO, without regard to whether the execution would trade through another market's protected quotation.<sup>34</sup> 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 placed in the Matching System and displayed, without regard to whether that display would lock or cross

---

<sup>32</sup> These order types – and other expressly-identified provisions – take effect with the implementation of Rule 611 of Reg. NMS. 17 CFR 242.611. The Exchange will use February 5, 2007 (the "Trading Phase Date") as the effective date for these provisions. 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).

<sup>33</sup> The Exchange initially has limited the use of this order type to its institutional brokers to ensure that the Exchange can determine whether or not the requirements of Rule 611(b)(7) Reg. NMS have been met. See CHX Article 20, Rule 4(b)(2). A benchmark order may execute at any price, without regard to the protected NBBO and may represent interest of one or more Exchange participants.

<sup>34</sup> See CHX Article 20, Rule 4(b)(1). These orders are executed based on the premise that the participant routing the order to the Matching System has already satisfied the protected quotations of other market centers. See CHX Article 20, Rule 6(c)(3).

another market center.<sup>35</sup> Two other Reg. NMS-related orders – an outbound ISO and a price-penetrating ISO – would also be accepted by the Exchange’s Matching System.<sup>36</sup>

Finally, the Matching System would accept do-not-display and do not route orders. A do not route order, as its name implies, would be executed or displayed within the Matching System and could not be routed to another market center.<sup>37</sup> A do-not-display order would be an order, for at least 1,000 shares when entered, that should not be displayed in whole or in part, but that would remain eligible for execution within the Matching System.<sup>38</sup>

---

<sup>35</sup> These orders are displayed based on the premise that the participant routing the order to the Matching System has already satisfied the quotations of other markets so that the display of the order would not lock or cross those markets.

<sup>36</sup> An outbound ISO would allow an Exchange participant to ask the Exchange to execute an order on the Exchange without regard to the protected quotations at other markets while simultaneously routing ISOs to those other markets to execute against their protected quotations. See CHX Article 20, Rule 4(b)(17). 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. See CHX Article 20, Rule 4(b)(18).

<sup>37</sup> As further described in the section relating to the prevention of trade-throughs, 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 deemed to have been received with a “do not route” condition because these orders either are immediately executed in the Matching System or cancelled. See CHX Article 20, Rule 4(b)(10).

<sup>38</sup> See CHX Article 20, Rule 4(b)(9). A do-not-display order could receive that designation because a customer specifically instructed a participant not to display the order or because a participant decided that its own order should not be displayed. As described later in this submission, a do-not-display order would be ranked, at any given price point, behind displayed orders (and any odd-lot and mixed-lot orders at the price) and behind the undisplayed portions of any reserve size orders. These completely undisplayed orders would both allow a participant to fulfill a customer’s instructions and to otherwise keep trading interest hidden, but to remain within the Matching System where the orders could be executed against inbound orders seeking liquidity.

5. Ranking of orders in the Matching System. As described in CHX Article 20, Rule 8, 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 orders. Specifically, orders received by the Matching System would be ranked as follows:

a. Orders that are eligible for display, as well as mixed-lot and odd lot orders. 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.<sup>39</sup>

b. Orders that are displayed in part, where a portion is not displayed. 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.

c. Completely undisplayed orders. 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.

Changes to an order's size or price, or its displayed portion, could impact its ranking within the Matching System. For example, when the displayed portion of a reserve size order is

---

<sup>39</sup> For the most part, executions in the Matching System would occur on a "share-for-share" basis, regardless of whether the incoming or resting orders were round-lot, mixed-lot or odd-lot orders. The one exception to this share-for-share matching is in the handling of ITS commitments or linkage plan orders, which would only be matched in round-lot increments, for the full amount of round-lot shares available at the price reflected in the NBBO. See CHX Article 20, Rule 8(e)(9). Any remaining portion of the ITS commitment or linkage plan order would then be automatically cancelled.

refreshed with new volume, the displayed portion of the order would receive a new ranking based on the time at which it was refreshed.<sup>40</sup> Similarly, if a participant increases the number of shares in a fully-displayed order, that order would receive a new ranking based on the time at which these shares were added to the order.<sup>41</sup> Any change in the price of an order would result in a new price and time ranking for the order, based on the time of the price change.<sup>42</sup> Finally, any change to the display instruction associated with an order would result in a new ranking for the order based on the time that the new instruction was received.<sup>43</sup>

6. Display of orders within the Matching System. 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. In addition, 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 for display purposes.<sup>44</sup> The undisplayed portion of a reserve size order and any other orders received with a do-not-display instruction would not be eligible for display.

---

<sup>40</sup> See CHX Article 20, Rule 8(b)(4). Any remaining undisplayed portion of the order would continue to be ranked at the price and time at which it was originally received.

<sup>41</sup> See CHX Article 20, Rule 8(b)(5). Any reduction in the number of shares in an order, however, would not change its ranking within the Matching System.

<sup>42</sup> Id.

<sup>43</sup> Id.

<sup>44</sup> This aggregation and rounding process would apply for display purposes only; all orders would retain their rankings for execution purposes as described in CHX Article 20, Rule 8(b)(1) through (5). However, as noted in CHX Article 20, Rule 8(g), the Matching System would report each round-lot transaction that occurs within the Matching System, including executions of resting odd-lot orders that have been aggregated into one or more round-lots for display purposes, to the appropriate consolidated reporting system.

The Exchange believes that its disseminated quotations would constitute automated quotations under the definition set out in Rule 600(b)(3) of Reg. NMS.<sup>45</sup> The Exchange's proposed rules confirm that each order submitted to the Matching System must be a firm order and cannot be identified as a "manual" quotation.<sup>46</sup>

7. Opening of the regular trading session. Immediately after the primary market opens, the Matching System would execute all opening cross orders, then start accepting and matching orders as provided in CHX Article 20, Rule 8(d).<sup>47</sup> If the primary market in a security other than a Nasdaq-listed security opens with a quote, but has not reported a trade for 30 seconds following the dissemination of the initial quote, the Matching System would cancel all opening cross orders, and then start accepting and matching all other orders.<sup>48</sup>

8. Automated matching of orders. With certain exceptions specifically set out in CHX Article 20, Rule 8(e), and subject to the provisions relating to the prevention of trade throughs that are set out in CHX Article 20, Rule 5, incoming orders would be matched against one or more orders in the Matching System, in the order of their ranking, at the price of each

---

<sup>45</sup> As required by Rule 600(b)(3) of Reg. NMS in its definition of "automated quotations," the Exchange's Matching System is designed to accept IOC orders; to immediately and automatically execute an IOC order against the displayed BBO, up to its full size; to immediately and automatically cancel any unexecuted portion of the IOC order without routing the order elsewhere; to immediately and automatically transmit a response to the order-sending participant indicating the action taken on the order; and to immediately and automatically update the BBO to reflect any change that occurred as a result of the execution.

<sup>46</sup> See CHX Article 20, Rule 3(a).

<sup>47</sup> See CHX Article 20, Rule 8(d).

<sup>48</sup> Id. This provision would apply only to securities other than Nasdaq-listed securities. As noted above, Nasdaq-listed securities would open based on the first unlocked, uncrossed market that occurs on or after 8:30 a.m.

resting order, for the full amount of shares available at that price or for the size of the incoming order, if smaller.<sup>49</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), it or its residual portion would be placed in the Matching System and ranked as described above.<sup>50</sup>

The following order types would be subject to specific executions within the Matching System:

a. Benchmark orders. Benchmark orders, which are cross transactions submitted by institutional brokers that meet the requirements of Rule 611(b)(7) of Reg. NMS, would execute at any price, without regard to the NBBO and may represent the interest of one or more participants of the Exchange.<sup>51</sup>

b. Cross and cross with size orders. Cross and cross with size orders would be automatically executed if they meet the requirements set out in Rule 4(b)(4) and (6) respectively, but would be immediately and automatically cancelled if they do not meet these requirements.<sup>52</sup>

---

<sup>49</sup> See CHX Article 20, Rule 8(d)(1).

<sup>50</sup> See CHX Article 20, Rule 8(d)(2). Orders that would be immediately cancelled, if not executed, include FOK orders and IOC limit and market orders. See CHX Article 20, Rules 4(b)(11) through (13).

<sup>51</sup> See CHX Article 20, Rule 8(e)(1) and Rule 4(b)(2). A benchmark order is defined in Rule 611(b)(7) of Reg. NMS as an order that is executed at a price that was not based, directly or indirectly, on the quoted price of the security at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made.

<sup>52</sup> See CHX Article 20, Rule 8(e)(1).

c. Cross with satisfy orders. In executing this order type, 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.<sup>53</sup>

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 Reg. 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.

d. Cross with yield orders. When the customer order that is part of a cross with yield order is eligible for an immediate execution because it is at a price better than the currently displayed best bid or offer in the Matching System, the cross with yield order would be automatically executed by matching the participant as principal against the customer order; provided, however, that if there is any order already displayed in the Matching System at the

---

<sup>53</sup> See CHX Article 20, Rule 8(e)(4).

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.<sup>54</sup> If the customer order that is part of a cross with yield order is not eligible for an immediate execution because it is not better than the currently displayed bid or offer in the Matching System, the cross with yield order would be immediately and automatically cancelled.

e. Midpoint cross. A midpoint cross order would be immediately executed at the midpoint between the NBBO. If the NBBO is locked at the time the order is received, the midpoint cross would be executed at the locked market price, unless the order could be executed in subpenny increments. If the NBBO is crossed at the time the order is received, the midpoint cross would be immediately and automatically cancelled.<sup>55</sup>

f. Non-regular way cross orders. 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>56</sup>

g. Sell short orders. 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") and Regulation SHO.<sup>57</sup> When a sell short order cannot be executed or

---

<sup>54</sup> See CHX Article 20, Rule 8(e)(2).

<sup>55</sup> See CHX Article 20, Rule 4(b)(14).

<sup>56</sup> See CHX Article 20, Rule 4(b)(15).

<sup>57</sup> Because there is no exemption from the requirements of the Short Sale Rule or Reg. SHO for odd lots executed within a system such as the Matching System, odd lot orders would be treated as all other orders in determining whether they could be executed under the Short Sale Rule and Reg. SHO.

displayed at its limit price under the provisions of the Short Sale Rule and Regulation SHO, the order would be automatically repriced (without violating its limit price) to the next available price at which it can be executed or displayed.<sup>58</sup>

h. Do not display orders. A do-not-display order would be executed as provided in CHX Rule 8(d), but 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>59</sup>

i. Inbound ITS commitment or linkage plan order. An inbound ITS commitment or linkage plan order, if it is priced at or better than the current Exchange-displayed BBO (or if it is marked “market”), would be automatically matched, in round-lot increments, against the order(s) at the price reflected in the BBO (or at a better undisplayed price), for the full amount of round-lot shares available at that price, and any remaining portion of the ITS commitment or linkage plan order would be automatically cancelled.<sup>60</sup> An inbound ITS commitment marked as a “block” trade would be automatically matched, in round-lot increments, at the price reflected in the ITS commitment, against the order(s) in the Matching System, in regular price-time priority.

j. Trades in locked markets. Trades would continue to be executed in the Matching System when the NBBO is crossed; provided however, that (i) if the ITS Plan

---

<sup>58</sup> See CHX Article 20, Rule 8(e)(5).

<sup>59</sup> See CHX Article 20, Rule 8(e)(6).

<sup>60</sup> See CHX Article 20, Rule 8(e)(7). The Exchange believes that this handling of ITS commitments and linkage plan orders is consistent with the ITS Plan and the current draft of the linkage plan that might replace the ITS Plan.

requires that the Matching System route the inbound order to another market for execution, the Matching System would do so or, if the order is marked “do not route,” the Matching System would automatically cancel the order; and (ii) once Reg. NMS is implemented in a security, the Matching System would only execute orders in that security up to (but not beyond) the first uncrossed NBBO.<sup>61</sup>

9. Prevention of trade-throughs and other order routing. The Exchange’s Matching System would prevent the execution of all or a part of an inbound order for at least a round lot if the execution would cause an improper trade-through of another ITS market or if, when Reg. NMS is implemented for a security, the execution of all or a part of the order would be improper under Reg. NMS Rule 611.<sup>62</sup> 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.

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 commitments or orders to other markets to satisfy their protected quotes. In these situations, the Exchange’s systems would determine when, how and where these orders (or commitments) should be routed to satisfy protected quotes. The Exchange would route these orders (or commitments), at the participant’s election, either through the

---

<sup>61</sup> See CHX Article 20, Rule 5, Interpretation and Policy .01(e).

<sup>62</sup> See CHX Article 20, Rule 5. At least initially, however, the Exchange would not apply the “flickering quote” exception to Rule 611 of Reg. NMS (Reg. NMS Rule 611(b)(8)) when determining whether or not the execution of the order would create an improper trade-through.

Intermarket Trading System (or any later linkage that supersedes ITS) or through the connectivity provided by a routing services provider with whom the Exchange has negotiated an agreement.

The Exchange will provide these routing services pursuant to the terms of three separate agreements, to the extent that they are applicable to a specific routing decision: (1) an agreement between the Exchange and each Participant on whose behalf orders will be routed (“Participant-Exchange Agreement”); (2) an 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 (“Give-Up Agreement”); and (3) an agreement between the Exchange and the specified third-party broker-dealer (“Routing Connectivity Agreement”) pursuant to which the third-party broker-dealer agrees to provide routing connectivity to other markets and serve as a “give-up” for the Exchange’s Participants in other markets. The Exchange will provide these routing services in compliance with its rules and with the provisions of the Act and the rules thereunder, including, but not limited to, the requirements of Sections 6(b)(4) and (5) of the Act that the rules of a national securities exchange provide for the equitable allocation of reasonable dues, fees and other charges among its members and issuers and other persons using its facilities, and not be designed to permit unfair discrimination between customers, issuers, brokers or dealers. The Routing Connectivity Agreement will include terms and conditions that enable the Exchange to comply with these obligations.

In addition to these routing services, the Exchange is developing a functionality that would, in all other situations where the execution of an inbound round lot order, in whole or in part, would cause a trade-through, (a) route the order to another venue, according to each participant's instructions, or (b) if the order is marked "do not route," automatically cancel the order.<sup>63</sup> The Exchange plans to supplement this filing, or file a new rule submission, with respect to this functionality, as soon as possible.

The Exchange has developed an initial series of trade-through policies and procedures that describe how the Exchange will implement the provisions of Rule 611 of Reg. NMS.<sup>64</sup> These procedures describe the Exchange's clock synchronization practices, as well as its plans for applying the exceptions to Rule 611 of Reg. NMS.<sup>65</sup> Among other things, these procedures confirm that the Exchange would apply the self-help exception (and disregard another market's quotations for trade-through purposes) when that market has publicly announced that it is not disseminating automated quotations (but has not identified those quotes as manual); or when the Exchange has a reasonable basis for believing that the other market is experiencing systems

---

<sup>63</sup> There would be one exception to the general rule that an inbound "do not route" order would be cancelled if its execution would constitute an improper trade-through. If an undisplayed order is resting in the Matching System and the execution of an inbound order (that is not an IOC or FOK order) against the undisplayed resting order would cause an improper trade-through, the resting order would be cancelled to the extent necessary to allow the inbound order to be executed or quoted.

<sup>64</sup> See CHX Article 20, Rule 5, Interpretation and Policy .01. The Exchange will further define its policies in more detail over the next month or so.

<sup>65</sup> The Exchange's systems will routinely, throughout the trading day, use processes that capture the time reflected on the atomic clock operated by the National Institute of Standards and Technology and will automatically make adjustments to the time recorded in the Exchange's Matching System to ensure that the period between the two times does not exceed 500 milliseconds.

problems and that market (a) has not responded, within 30 seconds, to an Exchange inquiry seeking information about possible systems problems, or (b) has not confirmed, within two minutes after an Exchange inquiry, that it is not having systems problems.<sup>66</sup> These procedures also confirm that the Exchange automatically would place an appropriate modifier on trades executed pursuant to an exemption from, or exception to, Rule 611 of Reg. NMS in accordance with specifications approved by the operating committee of the relevant national market system plan for an NMS stock.<sup>67</sup>

The Exchange's initial trade-through policies also describe its plans for confirming that its own bids and offers qualify as automated quotations. Specifically, the Exchange would periodically (no less often than once every five seconds and no more often than once every second) send a test IOC order to the Matching System to determine whether the Exchange's Matching System accepts the order and would use automated monitoring systems to further

---

<sup>66</sup> See CHX Article 20, Rule 5, Interpretation and Policy .01(d). The Exchange would notify the other market of its use of the self-help exception by using appropriate technology made available for intermarket communications from time to time. The Exchange then would continue to apply this self-help exception until the other market has provided reasonable assurance to the Exchange (or to the public) that the problems have been corrected.

<sup>67</sup> See CHX Article 20, Rule 5, Interpretation and Policy .01(h). In addition, if an on-Exchange participant submits an outbound ISO order (consisting of an order to execute on the Exchange, coupled with outbound ISOs to execute against protected quotations of other markets), the Matching System will not execute the order on the Exchange until it either simultaneously routes ISOs to other markets or confirms that the participant submitting the order has simultaneously routed ISOs designed to execute against the full size of any other market's protected bid or offer, as required by Rule 600(b)(30) and Rule 611(b)(6) of Reg. NMS.

measure the Matching System's handling of test IOC orders within the Matching System.<sup>68</sup>

These monitoring systems would provide immediate reports to other Exchange systems for further handling. If these systems receive a report that gives the Exchange reason to believe that it is not capable of displaying automated quotations, the Exchange would automatically and immediately append a "manual" identifier to the bids and offers it makes publicly available.<sup>69</sup>

The Exchange would not remove this "manual" identifier until it has determined that its quotations qualify as automated quotations. It would then notify other markets that its quotations are automated to ensure that all markets recognize the Exchange's bids and offers as automated quotations.

10. Locking and crossing quotations. An order would not be displayed on the Exchange if its display would improperly lock or cross the ITS best bid or offer or, when Reg. NMS is implemented for a security, if its display would constitute a locking or crossing

---

<sup>68</sup> These systems would review, in real time, the Matching System's handling of test IOC orders to determine whether, and within what time frame, (i) IOC orders are executed against the displayed quote, up to its full size; (ii) any unexecuted portion of the IOC order is cancelled; (iii) 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 (iv) 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). See CHX Article 20, Rule 5, Interpretation and Policy .02(a).

<sup>69</sup> In the event that the Exchange's systems do not permit the Exchange to disseminate a "manual" identifier, the Exchange would announce that its quotes are manual over an appropriate functionality available for communications with other market centers. See CHX Article 20, Rule 5, Interpretation and Policy .02(b).

quotation.<sup>70</sup> These otherwise locking or crossing orders would either be routed to another appropriate market or, if designated as “do not route,” would be automatically cancelled.

11. Clearing the matching system. To ensure that orders on the Exchange have an appropriate opportunity to interact with each other, institutional brokers ordinarily would be required to clear the Matching System before sending an order to another market for execution.<sup>71</sup> Any outbound ITS commitments that are seeking liquidity in another market – whether they represent agency or proprietary interest – would be required to first clear the displayed and undisplayed orders in the Exchange’s Matching System before being sent through the ITS System. Outbound ITS commitments (or ISOs) that are being sent to another market to satisfy its displayed bid or offer, however, would not be required to clear the Exchange’s Matching System before being sent to the other market.<sup>72</sup> Additionally, an institutional broker would not be required to clear the Matching System if the customer order that is being sent to another market could not be executed in the Matching System (e.g., the order is a stop or stop limit order which has not yet been elected).<sup>73</sup>

12. Trading halts. Under the proposed rules, two senior officers of the Exchange would be authorized to suspend and restart trading within a trading session or to halt trading for the remainder of a trading session, in one or more securities, when the officials

---

<sup>70</sup> See CHX Article 20, Rule 6(d).

<sup>71</sup> If a customer specifically requests otherwise, an institutional broker is not required to clear the Matching System. See CHX Article 20, Rule 7(a). Institutional brokers would be required to document any directives for special handling of orders under this rule. See CHX Article 20, Rule 7(b).

<sup>72</sup> See CHX Article 20, Rule 7(c).

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

believe it is in the public interest.<sup>74</sup> If trading in one or more issues is suspended or halted, the Matching System would not accept any additional orders and would resume quoting and matching orders only after the end of the trading halt.<sup>75</sup> Because the Matching System would not be locked or crossed when trading is halted, and because it would not accept orders during the halt, the Matching System would be able to emerge from the halt without any special reopening process, by simply displaying its BBO and then accepting and matching orders as provided by the Matching System rules described above.

13. Cancelling transactions/handling clearly erroneous transactions. Under the proposed rules, participants that make a transaction in demonstrable error could agree to cancel and unwind the transaction, subject to the approval of the Exchange.<sup>76</sup> The Exchange also proposes to extend its current electronic book rule for the handling of clearly erroneous transactions, with a few minor changes, to the operation of the Matching System.<sup>77</sup> This rule would allow the Exchange to review, and potentially modify or cancel, executions where one party believes that the terms of the transaction were clearly erroneous when submitted. A related rule relating to systems disruptions and malfunctions would allow the Exchange to modify or

---

<sup>74</sup> See CHX Article 20, Rule 1(d). Under the Exchange's current rules, a trading halt could be declared by the chairman or vice chairman of the Exchange's Board of Directors, or by its president, with the prior approval of a director from a participant firm and a director from the trading floor. The Exchange believes that it no longer is appropriate or effective to require its directors to participate in the decisions to suspend or halt trading, particularly with the automated environment proposed by the new trading model and the fact that the Exchange will no longer be operating a trading floor.

<sup>75</sup> See CHX Article 20, Rule 1, Interpretation and Policy .02. Participants could cancel orders during the halt.

<sup>76</sup> See CHX Article 20, Rule 9.

<sup>77</sup> See CHX Article 20, Rule 10; see also CHX Article XXA, Rule 7 (the policy approved for use within the electronic book).

cancel executions that result from a disruption or malfunction in the use or operation of the Matching System, or any communications system associated with the Matching System or when extraordinary market conditions or other circumstances exist in which the nullification or modification of transactions may be necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest. The proposed rules set out procedures for each of these reviews, including specific means for participants to appeal the Exchange's decisions.<sup>78</sup>

14. The late trading session. The Exchange's Matching System would begin accepting orders for the late trading session immediately after the closing of the regular trading

---

<sup>78</sup> For example, a participant seeking review of a "clearly erroneous" transaction would be required to notify the Exchange of the request immediately after the execution by telephone, and within 15 minutes after the execution in writing. The Exchange would promptly notify the other party to the transaction. Both parties then would be required to submit information relating to the disputed transaction, within specified time frames. After reviewing the transaction, an Exchange official would notify both parties of his or her decision, in writing; either party could appeal the decision to a subcommittee of the Exchange's Committee on Exchange Procedure and, if not satisfied, to the full Committee on Exchange Procedure. In making his or her decision, the Exchange official would consider the goals of maintaining a fair and orderly market and protecting investors and the public interest; if an Exchange official determines that a transaction was clearly erroneous, he or she would try to return the parties to the positions that they would have been in (or positions reasonably similar to those positions) if the error had not occurred. Similarly, in the event of a disruption or malfunction that impacts the operation or use of the Matching System (or in the event of extraordinary market conditions or other circumstances), an Exchange official could declare transactions void or modify transactions. Absent extraordinary circumstances, any Exchange action to void or modify transactions in this manner must be taken within 30 minutes of detection of the erroneous transaction, but in no event later than 2:00 p.m. on the trading day following the date of the trade at issue. The official would be required to notify each member involved in the transaction as soon as practicable after making any decision; decisions could be appealed using the procedure set out for the review of decisions addressing clearly erroneous transactions.

session.<sup>79</sup> Orders for the late trading session would be matched according to the same process used during the regular trading session. As noted above, the late trading session would end at 3:30 p.m.

**b. Market Makers**

The Exchange's proposed new trading model would allow participants to register to act as proprietary market makers on the Exchange. The provisions that would govern the activities of these market makers are set out in the proposed rules in CHX Article 16. These proposed rules replace the current market maker rules contained in CHX Article XXXIV.

Under the proposed rules, a participant firm seeking to act as a market maker would be required to register with the Exchange.<sup>80</sup> Participant firms would be required to register as market makers; individual traders within those firms would be required to separately register as market maker traders.<sup>81</sup> The proposed rules specifically provide that a market maker that is a participant in the Exchange, but is not a member of another self-regulatory organization, would be permitted to trade only on a proprietary basis and would not be permitted to handle any agency orders on the Exchange.<sup>82</sup> More than one market maker could register in each security.<sup>83</sup>

A participant would register as a market maker by submitting an application to the Exchange, confirming its ability to comply with applicable rules and identifying the number of

---

<sup>79</sup> See CHX Article 20, Rule 8(c)(2). Orders for the late trading session would not be allowed queue before the close of the regular trading session; they would only be accepted by the Exchange after the close of the regular trading session.

<sup>80</sup> See CHX Article 16, Rule 1(a). A participant would be not be considered to be acting as a market maker unless it was registered in that capacity and was in good standing.

<sup>81</sup> See CHX Article 16, Rule 1, Interpretation and Policy .01.

<sup>82</sup> See CHX Article 16, Rule 1, Interpretation and Policy .02.

<sup>83</sup> See CHX Article 16, Rule 3, Interpretation and Policy .03.

securities in which it seeks to make markets.<sup>84</sup> The Exchange would review each application and, using specific criteria, would determine whether or not the participant should be registered in that capacity.<sup>85</sup> The Exchange would notify each participant of the action taken with respect to its application and, if it denies a participant's registration request, would describe the reasons for that denial.<sup>86</sup> An unsuccessful applicant would be permitted to seek a review from that decision pursuant to the provisions of CHX Article 15.<sup>87</sup>

Under the proposed rules, once a firm's market maker registration is approved, the firm could select the securities in which it would act as market maker by notifying the Exchange.<sup>88</sup> The Exchange would require a firm to seek prior approval before acting as market maker in more than 500 securities and with respect to each increment of an additional 100 securities after that

---

<sup>84</sup> See CHX Article 16, Rule 2(b).

<sup>85</sup> See CHX Article 16, Rule 3. In considering a participant's request for registration as a market maker, the Exchange would consider: (a) the participant's financial resources; (b) the participant's experience and demonstrated ability in making markets, including the depth and quality of the market quoted by the participant in other securities; (c) the participant's demonstrated ability to make markets in such a manner as to increase the order flow to the Exchange and, as a result, the competitiveness of its market with markets elsewhere; (d) the participant's disciplinary record, including its violations of Exchange rules, the rules of other SROs and federal securities laws; (e) the participant's operational capability, including its ability to comply with the responsibilities set out in CHX Article 16, Rule 8; and (f) the overall best interests of the Exchange.

<sup>86</sup> See CHX Article 16, Rule 2(d).

<sup>87</sup> See CHX Article 16, Rule 2(d).

<sup>88</sup> See CHX Article 16, Rule 5. A market maker would be required to notify the Exchange of a decision to add or drop securities by 9 a.m. on the trading day preceding the date on which the change would take effect, unless the Exchange is able to accommodate a notification closer to the effective date. Id.

threshold is reached.<sup>89</sup> If a market maker drops a security from its selected list, that participant would not be allowed to trade that security again as market maker for 20 calendar days.<sup>90</sup>

A firm's registration as a market maker could be terminated voluntarily, by the market maker itself, or involuntarily, by the Exchange.<sup>91</sup> The proposed rules would allow market makers to voluntarily deregister by filing the appropriate form with the Exchange. As part of that process, a firm would be permitted to request temporary or partial deregistration as a market maker – and thus avoid the need to complete the registration process again – in specific circumstances that temporarily prevent a market maker from acting in that role.<sup>92</sup> Under the proposed rules, the Exchange could grant a request for temporary or partial deregistration for up to 60 days and could extend that period in its discretion. The proposed rules would allow the Exchange to suspend, terminate or limit a market maker's registration upon a determination of

---

<sup>89</sup> See CHX Article 16, Rule 5, Interpretation and Policy .01. This process would allow the Exchange to evaluate a market maker's request, using the criteria in CHX Rule 3, to determine whether the firm appears capable of handling its market maker responsibilities in these additional issues.

<sup>90</sup> See CHX Article 16, Rule 5, Interpretation and Policy .02. This prohibition would not apply where a market maker has received approval to voluntarily deregister as a market maker under the provisions of CHX Article 16, Rule 6.

<sup>91</sup> See CHX Article 16, Rules 6 (voluntary deregistration) and 7 (involuntary deregistration). In addition, the Exchange would consider a firm to have deregistered if it is not trading any securities as a market maker (*i.e.*, it is not submitting bids or offers in the securities it has selected). See CHX Article 16, Rule 6. If a firm is deemed to have deregistered, it would be required to complete the registration process again before acting as a market maker on the Exchange.

<sup>92</sup> These reasons include software, hardware, connectivity or other problems that interfere with the market maker's ability to appropriately send bids or offers to the Exchange or otherwise act as market maker; legal or regulatory considerations that temporarily prevent the participant from acting as market maker; or other circumstances, including, but not limited to, those that are beyond a market maker's control, that interfere with the participant's ability to act as market maker. See CHX Article 16, Rule 6, Interpretation and Policy .01.

any substantial or continued failure by the participant to engage in dealings as required by CHX Article 16, Rule 8 or as set out in CHX Article 13.<sup>93</sup>

During the Exchange's regular trading session, 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; (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>94</sup> A market maker's continuous two-sided quotes must be at prices which are reasonably related to the prevailing market price of the security.<sup>95</sup>

---

<sup>93</sup> CHX Article 13 contains the Exchange's rules and procedures relating to the suspension and reinstatement of a participant's ability to act as a participant and to retain its registration in a special capacity (such as a market maker).

<sup>94</sup> See CHX Article 16, Rule 8(a) through (c). Over the course of each calendar month, a market maker would be required to meet either of these requirements: (1) at least 5% of the total number of a market maker's principal bids or offers on the Exchange, in each quarter, for each of its assigned securities, must, when entered on the Exchange, be at the NBBO or improve the NBBO in a manner that attributes market data revenue to the Exchange under the terms of applicable national market system reporting plans; or (2) the shares traded by a market maker for its own account, for each of its assigned issues, must equal or exceed 1% of the total number of shares executed on the Exchange in that issue.

<sup>95</sup> See CHX Article 16, Rule 8, Interpretation and Policy .01. The proposed rules provide that, in most circumstances, a market maker's quotations should be priced no more than 10% away from the prevailing NBBO (as applicable) for securities priced under \$1.00, 5% for securities priced between \$1.00 and \$50.00 and 3% for securities priced above \$50.00. This quoting guidance is substantially similar to that currently provided by the Exchange's Market Regulation Department to participants (such as specialists and market makers) that have a quoting obligation on the Exchange.

Market makers would have two other specific obligations. First, 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, and describe to the Exchange, information barriers that prevent the market maker from using material, non-public information or information about customer order flow in its trading activities.<sup>96</sup> And, second, a market maker would be required to record and, provide upon request, to the Exchange in an approved electronic format, its long or short position in a security as of the time that it initiates an order in that security on the Exchange.<sup>97</sup>

**c. Institutional Brokers**

Under the Exchange's proposed new trading model, any participant firm that acts as a broker in effecting transactions on the Exchange and for which the Exchange is the designated examining authority would be permitted to register with the Exchange as an institutional broker and to use Exchange systems for handling orders and reporting transactions.<sup>98</sup> Each individual that would be authorized to effect trades on behalf of the firm would be required to separately

---

<sup>96</sup> See CHX Article 16, Rule 9. At the time a participant becomes a market maker, the participant would be required to submit a written statement describing its plans for establishing and maintaining the required information barriers, including the internal controls that will be put in place to monitor the barriers' effectiveness. A market maker engaging in these other business activities would not be allowed to act as a market maker on the Exchange until the Exchange had approved the information barrier procedures.

<sup>97</sup> See CHX Article 16, Rule 10. The requirement to report information to the Exchange would apply only to market makers that are not NASD members. NASD members would provide this information directly to the NASD and would be subject to the NASD's oversight with respect to their trading activity.

<sup>98</sup> See CHX Article 17, Rule 1.

register as an institutional broker representative.<sup>99</sup> The Exchange anticipates that its existing floor brokers would register as institutional brokers in the new model. Importantly, although institutional brokers would operate as participants on the Exchange, they could trade from any location and would not effect transactions from a physical trading floor.<sup>100</sup>

Under the proposed rules, institutional brokers would be required to adhere to trading and business conduct rules that apply to participant firms generally and would be subject to specific obligations set out in CHX Article 17. Among other things, institutional brokers would be required to enter all orders received for execution on the Exchange into an automated system to provide an electronic record of their order handling practices; would be required to maintain separate accounts for handling agency transactions, principal transactions and transactions involving errors; and would be required to enter transactions into the appropriate accounts.<sup>101</sup>

---

<sup>99</sup> See CHX Article 17, Rule 1, Interpretation and Policy .02. This requirement essentially tracks the current requirement that individual floor brokers separately register with the Exchange and take required examinations. See CHX Article VI, Rules 2 and 3.

<sup>100</sup> As noted above, the Exchange would not operate a physical trading floor in the new trading model. The Exchange anticipates that it would continue to allow participants to remain in their current locations within the trading floor space, paying current rent, through the end of the year, at which time the trading floor space would be more formally subleased to interested parties (including participants) for use as office or trading space. The Exchange believes that it would be appropriate to allow participants to remain in their current locations on the floor (and to pay the current rent for that space) during, and for a short time after, the transition to the new trading model so that firms that choose to relocate are not unnecessarily required to disrupt their operations by both a transition to a new trading model and a physical relocation.

<sup>101</sup> See CHX Article 17, Rule 3(a) and Rule 3(c). The requirement for entering orders into an electronic system to permit the Exchange to more readily surveil broker order handling activities has been approved and implemented. See CHX Article 11, Rule 3; Securities Exchange Act Release No. 53772 (May 8, 2006), 71 FR 27758 (May 12, 2006). In addition, although the Exchange's current rules do not specifically require brokers to maintain specific principal, agency and error accounts, the Exchange's Market Regulation

Institutional brokers would also be required to maintain required records of their trading activities, including records of their relationships with their customers.<sup>102</sup> Finally, institutional brokers would be required to use an electronic system, acceptable to the Exchange, for the handling of orders that integrates the institutional broker's on-Exchange trading activities with the Matching System and with its trading activities in other market centers.<sup>103</sup>

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 that system. The proposed rules would also set out specific order handling obligations for institutional brokers.<sup>104</sup> Specifically, an institutional broker handling a market order would be required to use due diligence to execute the order at the best price or prices available.<sup>105</sup> Similarly, an institutional broker handling a limit order would be required to use due diligence to execute the order at or better than the limit price, if available. And, an institutional broker who has been given a not held order would be required to use brokerage judgment in the execution of the order, and if he exercises such judgment, would be relieved of all responsibility with respect

---

Department has encouraged them to do so as a way to evidence their compliance with general order handling obligations.

<sup>102</sup> See CHX Article 17, Rule 3(f).

<sup>103</sup> See CHX Article 17, Rule 3(b).

<sup>104</sup> See CHX Article 17, Rule 3(d). An institutional broker generally would execute its customers' orders on an agency basis. If, however, an institutional broker believes it is in the best interests of its customer to execute an order on a principal basis, it must comply with the requirements of CHX Article 9, Rule 18. See CHX Article 17, Rule 3(d)(4).

<sup>105</sup> In handling a market order, an institutional broker could assign an appropriate limit price to the order and send it to the Matching System, could enter an IOC market order into the Matching System or could route the order to another market center after clearing the Exchange's Matching System.

to the time of the order's execution and the execution price or prices given to the order.<sup>106</sup> These proposed rules are similar to rules that relate to broker trading activities on at least one other market and are designed to establish a specific standard by which institutional broker order handling activities could be measured.<sup>107</sup>

The final new requirement under the proposed rules would require that brokers use reasonable efforts to report all transactions that are not effected through the Exchange's Matching System to the Exchange within 10 seconds after the trade occurs.<sup>108</sup> Although the Exchange anticipates that most executions by its institutional brokers would occur within the Matching System, the Exchange recognizes that its institutional brokers could, from time to time, execute orders outside of that system. To ensure that the Exchange and its institutional brokers can establish compliance with the trade-through provisions of the ITS Plan and Rule 610 of Reg. NMS, the Exchange is developing functionality in its Brokerplex system that would allow an institutional broker to electronically validate whether a trade would constitute a trade-through before the trade occurs and that would create an electronic record that that validation had taken place.<sup>109</sup> Because of the possibility that a broker trading on a proprietary basis against a customer

---

<sup>106</sup> See CHX Article 17, Rule 3(d)(3).

<sup>107</sup> See NYSE Rule 123A.41-.44. The Exchange's Rules do not currently contain any specific order execution standards that apply to its brokers.

<sup>108</sup> See CHX Article 17, Rule 3(e). This provision would also require that an institutional broker mark as "SOLD" any trades reported after this time.

<sup>109</sup> See CHX Article 17, Rule 3, Interpretation and Policy .03. Other possible functionality might allow a broker to enter the details of a proposed cross transaction (such as its price, the number of shares and whether the sell side of the order is "short") into the Brokerplex system, which would send the cross to the Matching System for execution when it could be executed. The first type of functionality – to allow a broker to report a trade outside of the Matching System in a manner that is consistent with the NBBO and orders in the Matching System – is slated for roll-out to brokers in (or before) early October 2006.

order could use this functionality in a manner inconsistent with the broker’s fiduciary obligations to the customer order, the proposed rules would require a broker that pulls up the validation window to complete the required information and report the transaction (without cancelling out of the functionality) unless the broker mistakenly input the symbol for the wrong security or the transaction may be cancelled pursuant to the provisions set out in CHX Article 20, Rules 9, 10 and 11 (relating to cancellations of transactions, clearly erroneous transactions and systems disruptions and malfunctions).<sup>110</sup>

**d. Other Rule Changes**

1. CHX Article 1. (Definitions and General Information). Within this Article of the rules, the Exchange proposes to add new definitions for terms that are used elsewhere in the rules.<sup>111</sup> The Exchange also seeks to add two new sections – one new rule that lists and

---

<sup>110</sup> See CHX Article 17, Rule 3, Interpretation and Policy .03.

<sup>111</sup> These newly-defined terms include “Act” and “Exchange Act,” “Amex,” “BBO,” “CHX,” “CHX Holdings,” “institutional broker,” “NBBO,” “Nasdaq,” “NYSE,” “primary market,” “Rule 10a-1 and Regulation SHO,” “rules,” and “Securities Act.” The Exchange’s BBO would be the best bid or offer displayed in the Exchange’s Matching System. The NBBO would be described in reference to the definition used in Rule 600(b)(42) of Reg. NMS. The “primary market” – a term used largely to determine the execution price of opening cross orders – would mean, unless otherwise designated by the Exchange, the initial listing market for a security. References to the Exchange’s Rules would include the rules of the Exchange that have been adopted by the Exchange’s Board of Directors and that have either been approved by the Commission or become effective pursuant to Section 19(b)(3) of the Act. The Exchange proposes to delete the definitions of “floor” and to delete references to the trading floor from the “trading facilities” definition to reflect the fact that the Exchange will not be operating a physical trading floor in the new model.

defines types of orders and conditions and one new rule that confirms that all times identified in the rules are Central Time unless otherwise indicated.<sup>112</sup>

2. CHX Article 2. (Committees). The proposed changes to this Article eliminate references to the Exchange's trading floor and to the Exchange's current Committee on Specialist Assignment and Evaluation.<sup>113</sup> Under the proposed new model, the Exchange would no longer have specialists who are responsible for handling orders in each issue and thus there is not a need to have a committee to assign securities and evaluate specialist performance. The proposed changes also would confirm that the Committee on Exchange Procedure would consist of not less than seven participants, without specifying the specialized roles in which those persons must serve.<sup>114</sup>

3. CHX Article 3. (Participants). The primary substantive changes in this Article are designed to streamline the process of obtaining a trading permit on the Exchange. Under the Exchange's current rules, the Exchange's staff makes a preliminary determination about an applicant's qualifications and then posts the applicant's name to permit other

---

<sup>112</sup> See CHX Article 1, Rules 2 and 3. The order types and conditions set out in Rule 2 primarily are those that are accepted by the Exchange's Matching System and described in CHX Article 20, Rule 4. A few new definitions were added to clarify basic information such as the definition of "odd lot," "round lot" and "mixed lot." See CHX Article 1, Rules 2(w) (odd lot), 2(cc) (round lot) and 2(r) (mixed lot).

<sup>113</sup> See CHX Article 2, Rule 5 (removing references to the trading floor and to the Committee on Specialist Assignment and Evaluation); Rule 6 (deleting the description of the role of the Committee on Specialist Assignment and Evaluation); and Rule 10 (deleting references to the Exchange's trading floor).

<sup>114</sup> See CHX Article 2, Rule 5 (removing a requirement that three of the Committee members be active on the Exchange's Floor as specialists, odd-lot dealers or floor brokers). The Exchange believes that, with its move to the new trading model, it is no longer appropriate to mandate that Committee members trade in certain capacities and not others.

participants to submit any objections to that applicant's desire to trade on the Exchange. The Exchange believes that this posting process is not a necessary component of the application process – indeed, it appears to relate back to a time when information about a firm's prior business dealings might best be learned by talking with others in the business community. The electronic databases of information that are available today eliminate the need for this sort of process.<sup>115</sup>

There are three other groups of proposed changes within CHX Article 3. In CHX Rule 1, the Exchange seeks to eliminate the definitions that identify when a participant is engaging in a public securities business – these definitions do not relate to any particular requirement applicable to Exchange participants under the current rules. And, in CHX Rule 2, the Exchange proposes to replace references to “co-specialists,” “floor brokers” and “registered market makers” with references to “institutional broker representatives” and “market maker traders,” the terms used in CHX Articles 16 and 17 to refer to the individuals who would have special registration on the Exchange in the new model.

One final change to CHX Article 3 would create a more detailed limitation of liability provision that tracks similar provisions on other markets.<sup>116</sup> This provision would confirm that neither the Exchange, nor its affiliates, nor any of the directors, officers, committee members, officials, employees, contractors or agents of the Exchange or its affiliates would be liable to

---

<sup>115</sup> See CHX Article 3, Rules 3 and 4. Other changes to the application process would confirm that, with the posting process eliminated, Exchange staff would make the initial determination on each application for a trading permit. These changes also would refer applicants to a new CHX Article, CHX Article 15, for a single set of procedures for seeking review of Exchange decisions, such as the denial of a trading permit.

<sup>116</sup> See ISE Rule 705(a) and CBOE Rule 6.7A.

participants or persons associated with participants for any loss arising out of the use of the facilities, systems, services or equipment provided by the Exchange or for any loss associated with an interruption in, or in a failure or unavailability of, of any such facilities, systems, services or equipment, whether or not the loss resulted from negligence or other unintentional errors omissions or from any other cause within or without the Exchange's control.<sup>117</sup> The provision would also confirm that the Exchange makes no warranty as to results that might be obtained by persons using the Exchange's facilities or services or any data transmitted by or on behalf of the Exchange.<sup>118</sup> Other changes to this provision would bar a participant from instituting a legal proceeding against the Exchange, its affiliates or their directors, officer, committee members, officials, employees, contractors or agents for actions taken or omitted in connection with the official business of the Exchange, except to the extent that such actions or omissions constitute violations of the federal securities laws for which a private right of action exists.<sup>119</sup>

4. CHX Article 4. (Participant Firms). In this Article, the Exchange seeks to eliminate references to its trading floor and to floor brokers.<sup>120</sup> It also proposes to change existing requirements relating to the nominees and voting designees named on trading permits to confirm that any person affiliated with a participant firm, not just a general partner of the firm, who is acting as an institutional broker representative or a market maker trader can be named as a

---

<sup>117</sup> See the full text of this provision at CHX Article 3, Rule 8(a).

<sup>118</sup> See the full text of this provision at CHX Article 3, Rule 8(b).

<sup>119</sup> See CHX Article 3, Rule 8(c) for the complete text of this provision. Importantly, this last provision would not apply to appeals of disciplinary actions or other actions by the Exchange for which an appellate right is provided by the rules.

<sup>120</sup> See CHX Article 4, Rules 4 and 15.

nominee on a trading permit.<sup>121</sup> Similarly, the Exchange proposes to confirm that any officer of a participant firm can be named as voting designee, not just the firm's president or one of its vice presidents.<sup>122</sup> These changes are designed to reflect the fact that participant firms are structured in various ways – some are partnerships and others are not – and that the Exchange is concerned with an individual's authority to act on behalf of the firm, not whether he or she fits into a narrowly selected job title or role.<sup>123</sup>

5. CHX Article 5. (Access to the Exchange). Under the Exchange's current rules, this Article (entitled "Admission to Floor – Communications") contains rules describing visitor and employee access to the trading floor, the making of announcements on the floor and the connections that can be made to and from the Exchange's trading floor.<sup>124</sup> Because the Exchange would not operate a physical trading floor in its new model, the Exchange proposes to delete these rules and to replace them with rules that contemplate remote access to the Exchange's automated trading systems. These proposed new rules would begin by requiring that participants have reasonable procedures to maintain the physical security of the equipment and systems used to access the Exchange and to maintain an updated list of the persons who can

---

<sup>121</sup> See CHX Article 4, Rule 13(b).

<sup>122</sup> See CHX Article 4, Rule 13(c).

<sup>123</sup> Other proposed changes in this Article correct a misspelling (CHX Rule 4) and clarify that participants do not "own" trading permits, they "hold" them. (CHX Rule 13(a)).

<sup>124</sup> One of these provisions, CHX Rule 4, contains a new interpretation and policy that requires participants to provide specific information to the Exchange about connections to, and orders handled through, layoff vendors. The Exchange proposes to move this provision to CHX Article 11, its new Books and Records rule.

obtain access to the Exchange on the Participant's behalf.<sup>125</sup> Another rule would confirm that, as a condition of obtaining access to the Exchange, each participant agrees to pay Exchange fees, including fees associated with the routing of orders to other markets.<sup>126</sup>

One of the last proposed new rules in this Article would set out a structure through which Exchange participants could provide non-participant broker-dealers with access to the Exchange, through clearing arrangements or otherwise.<sup>127</sup> Under this proposed rule, this type of sponsored access could be provided so long as the participant sponsoring access (the "sponsoring participant"), the non-participant broker-dealer and the Exchange entered into appropriate agreements confirming basic information about the roles and responsibilities of the various parties. These agreements would confirm that: (1) all orders submitted by the non-participant broker-dealer, and any executions resulting from those orders, are binding in all respects on the sponsoring participant; (2) the sponsoring participant is responsible for all actions taken and fees incurred in connection with any order submitted or transaction executed by the non-participant broker-dealer; (3) in all matters relating to the non-participant's access to the Exchange and its use of Exchange facilities, the Exchange would communicate with the sponsoring participant and would not be required to communicate with the non-participant at any time; (4) the non-participant broker-dealer would have reasonable procedures to maintain the physical security of the equipment used to access the Exchange to prevent improper use of, or access to, the Exchange; and (5) the sponsoring participant would indemnify and hold the Exchange harmless

---

<sup>125</sup> See CHX Article 5, Rule 1.

<sup>126</sup> See CHX Article 5, Rule 2.

<sup>127</sup> See CHX Article 5, Rule 3.

from any liability, loss, claim or expense which the Exchange may incur in connection with the agreement. The Exchange believes that these provisions provide sufficient assurances to the Exchange, to other participants using the Exchange's facilities and to the non-participants themselves that non-participant broker-dealer access to the Exchange's facilities would be subject to the same standards and obligations that apply to participant access.<sup>128</sup>

The final proposed rule in this Article would permit an appeal from a Market Regulation Department decision to deny access to a participant (or a non-participant broker-dealer) under any of the rules in the Article. Any appeal from such a decision would be made pursuant to the procedures set out in CHX Article 15.<sup>129</sup>

6. CHX Article 6. (Registration). In this Article, the proposed rule changes would begin by confirming that individuals acting as institutional broker representatives and market maker traders would be required to register with the Exchange and successfully complete certain written examinations.<sup>130</sup> Other proposed changes would set out more specific obligations relating to notifications that would need to be made to the Exchange when a registered or associated person is terminated and would require participant firms to notify the

---

<sup>128</sup> For example, because the sponsoring participant confirms that it is responsible for the non-participant's actions, the Exchange can enforce compliance with its rules through actions taken against the sponsoring participant. In addition, the non-participant (like a participant) would be required to use reasonable procedures to maintain the physical security of the equipment used to access the Exchange and the Exchange would communicate with the participant on all issues relating to the use of the Exchange's facilities.

<sup>129</sup> See CHX Article 5, Rule 4.

<sup>130</sup> See CHX Article 6, Rules 2(b)(7) and 3.

Exchange of any firm-related event constituting a statutory disqualification.<sup>131</sup> Additional changes would update the firm supervision rules to require participants to identify the person(s) responsible for acting as supervisors; to recognize that supervisory authority could be delegated and to establish the mechanism for doing so; to provide that, in the absence of a specific designation, the firm's general partner(s), president, chief executive officer or other principal executive officer would be deemed to have supervisory responsibility; to require firms to meet, at least annually, with staff about compliance matters; and to require firms to establish internal controls to assure that appropriate supervision is being exercised.<sup>132</sup> Other changes would require that a participant opening a branch office file a Form BR with the Exchange (instead of Schedule E to Form BD) and confirm that a participant must retain records that identify the names of all persons who are designated as supervisory personnel (and the dates for which those designations are effective) for six years (the first two years in an easily accessible place). Finally, the changes in this Article would add a new rule relating to fingerprinting of Exchange staff and contractors and would incorporate two rules that currently occur elsewhere in the Exchange's rules.<sup>133</sup>

---

<sup>131</sup> See CHX Article 6, Rule 2(e)-(f) and Interpretations and Policies .03 and .04.

<sup>132</sup> See CHX Article 6, Rule 5(a) (various provisions relating to the designation of persons with supervisory authority) and 5(c) (internal controls and training). These obligations are similar to those required by other SROs and would ensure that the Exchange's participant firms are strengthening the work that they do to supervise their registered and associated persons.

<sup>133</sup> See CHX Article 6, Rule 10 (fingerprinting) and Rules 8 and 9 (formerly, CHX Article VIII, Rule 16 and CHX Article VIII, Rule 11). Under the proposed fingerprinting rule, the Exchange would conduct fingerprint-based criminal records checks of all prospective employees, as well as of independent contractors and temporary employees who are expected to have access to Exchange facilities for more than 10 days. The Exchange would similarly conduct checks of persons who would have access to premises controlled

7. CHX Article 7. (Financial Responsibility and Reporting).<sup>134</sup> In this Article, the proposed rule changes would delete references to requirements that current apply to specialist firms and incorporate three fee-related provisions that currently appear in other Articles.<sup>135</sup>

8. CHX Article 8. (Business Conduct). As noted above, as part of its new model filing, the Exchange has sought to better organize its rules. Although there were some minor organizational changes in earlier Articles, the proposed changes in CHX Article 8 are somewhat more extensive.<sup>136</sup> Importantly, though, CHX Article 8 does not contain any

---

by CHX Holdings, when those premises are in the same building as Exchange facilities. This proposed rule would codify the Exchange's current practice of conducting these checks for prospective Exchange employees and would extend that practice to independent contractors and temporary workers who have more than fleeting access to Exchange facilities, as well as to other persons who have access to certain CHX Holdings premises.

<sup>134</sup> This Article previously was numbered CHX Article XI of the Exchange's Rules. The marked version of the rules in this submission compares the current CHX Article XI to the changes that would be made as part of the Exchange's new trading model, including the change in numbering. The provisions in current CHX Article VII have been moved to new CHX Article 13, as described below.

<sup>135</sup> The specialist-related provisions that would be deleted are shown in CHX Article 7, Rule 3. The three fee-related rules that would be added to this section – so that all fee-related provisions could be gathered as much as possible in one place – formerly were CHX Article XIV, Rules 1 (fixing and paying fees); 10 (failure to pay debts); and 11 (fees for participants in military service).

<sup>136</sup> To try to enhance a reader's ability to understand which rules the Exchange proposes to keep in force, the Exchange shows the reorganized rules as new text in the first section of Exhibit 5 and the existing rule text as deleted text in the second section of Exhibit 5. Some of these apparently deleted rules have not been completely removed; instead, they have been moved to other CHX Articles in the rulebook. See CHX Article VIII, Deleted Rules 3, 7, 9 and 17 (moved to CHX Article 9); Rules 8, 11 and 16 (moved to CHX Article 12); and Rule 23 and 24 (moved to new CHX Article 14).

completely new rule provisions; indeed, eleven of the sixteen proposed rules in this CHX Article have not been changed at all.<sup>137</sup> Instead, the rules in this section were gathered from throughout the Exchange's rulebook and, with three exceptions discussed below, are not substantially modified.<sup>138</sup>

The existing version of CHX Article VIII, Rule 21 extensively details how one participant firm must coordinate with another participant in the transfer of customer accounts. Because the Exchange is not the designated examining authority for any firm that carries participant accounts, the Exchange believes that this detailed recitation of account transfer procedures is not a necessary component of its rules. Instead, the Exchange proposes to adopt, in CHX Article 8, Rule 10, rule language similar to that used by other markets that have similarly constrained examining responsibilities.<sup>139</sup> Also, the Exchange has proposed revisions to CHX Rule 16 that would make the text relating to its policy against harassment and other conduct rules applicable, once the Exchange no longer operates a trading floor, to conduct that occurs on Exchange

---

<sup>137</sup> See CHX Article 8, Rules 2 (formerly Rule 12); 3 (formerly Rule 1); 4 (formerly Rule 5); 5 (formerly Rule 2); 8 (formerly Rule 18); 9 (formerly Rule 19); 11 (formerly Rule 25); 12 (formerly CHX Article XV, Rule 3); 13 (formerly CHX Article XIII); 14 (formerly CHX Article XXXIII) and 15 (formerly CHX Article XV, Rule 1).

<sup>138</sup> Small modifications include changes that would delete references to the trading floor, eliminate obsolete provisions or clarify wording. See CHX Article 8, Rule 1 (replacing the reference to "constitution" with a reference to the Exchange's "bylaws" and deleting the unnecessary word "Firm" in the first few words of the text); Rule 7 (eliminating references to non-participants on the trading floor and to employees of banks, insurance companies and other corporations); and Rule 8 (eliminating references to floor employees).

<sup>139</sup> See PCXE Rule 9.19.

premises, while conducting business on the Exchange or when interacting with Exchange staff who are conducting Exchange business.

The Exchange has proposed the deletion of several rules in the existing CHX Article VIII. As an initial matter, the Exchange seeks to delete CHX Article VIII, Rule 22 (Responsibility for Acts of Others), which identifies supervisory obligations that are much like those being added to CHX Article 6, Rule 5, as described above. Other provisions that would be deleted appear to be unnecessarily duplicative of existing Exchange authority or of provisions that are being retained or seem otherwise unnecessary for the regulation of the automated market which the Exchange will operate.<sup>140</sup>

9. CHX Article 9. (General Trading Rules). The Exchange proposes to reorganize CHX Article 9 in much the same manner as CHX Article 8.<sup>141</sup> The proposed changes to CHX Article 9 include only three new rules – relating to the reporting of transactions (including riskless principal transactions) and to the use of a customer’s give-up.<sup>142</sup> Other

---

<sup>140</sup> See e.g., CHX Article VIII, Rule 4 (Upsetting Market Equilibrium) and Rule 10 (Dealings on Market Price Fluctuations), which address issues similar to those set out in other Exchange rules, including CHX Article 9, Rule 11 (Price Manipulation). See also CHX Article VIII, Rule 8 (unnecessarily confirming that a participant, or a partner, officer, director or registered employee of a participant firm that is found guilty of conduct inconsistent with just and equitable principles of trade shall be expelled, suspended or disciplined).

<sup>141</sup> As above, the Exchange shows the reorganized rules as new text in the first section of Exhibit 5 and the existing rule text as deleted text in the second section of Exhibit 5.

<sup>142</sup> See CHX Article 9, Rules 13, 14 and 25. Proposed Rule 13 contains provisions that confirm that transactions on the Exchange may occur only in the Matching System or through an institutional broker and require institutional brokers to report all executions that occur on the Exchange (except for transactions that occur within the Matching System, because the Exchange has already stored information about those transactions). Proposed CHX Rule 14 sets out riskless principal trade reporting rules that are similar to those put in place by other markets and could be used by institutional brokers in their

provisions have been gathered from the text of the existing CHX Article IX and from other sections of the current rulebook and have been modified primarily to remove references to the Exchange's trading floor or to make other clarifications to the text.<sup>143</sup>

---

handling of customer orders. Most frequently, however, the Exchange anticipates that its institutional brokers would continue their current practice of acting on an agency, not riskless principal, basis when representing orders in other markets. Rule 14 confirms that the second, riskless principal leg of the riskless principal transaction is not required to clear the Matching System pursuant to CHX Article 20, Rule 7 and is not required to yield to orders otherwise resident on the Exchange.

<sup>143</sup> See CHX Article 9, Rules 1 (moved from CHX Article XX, Rule 1 and modified to state simply that the trading rules apply to trading on the Exchange); 2 (moved from CHX Article VIII, Rule 7 and modified to confirm that, even if not willful, a pattern or practice of rule violations may be considered conduct inconsistent with just and equitable principles of trade); 3 (moved from CHX Article XX, Rule 4 and modified to eliminate obsolete references to Exchange employees who are authorized to close contracts under the rule); 4 (moved from CHX Article IX, Rule 8); 5 (moved from CHX Article XX, Rule 6); 6 (moved from CHX Article XX, Rule 8 and modified to replace references to "bids and offers" with references to "orders"); 7 (moved from CHX Article XXVII, Rules 1 and 2); 8 (moved from CHX Article XX, Rule 3); 9 (moved from CHX Article VIII, Rule 3); 10 (moved from CHX Article XX, Rule 29); 11 (moved from CHX Article IX, Rule 6 and modified to confirm that the rule applies to both purchases and sales); 12 (moved from CHX Article IX, Rule 11); 16 (moved from CHX Article VIII, Rule 17); 17 (moved from CHX Article IX, Rule 5 and modified (i) to confirm that a participant may not execute an incoming order for its own account at a price less than a penny better than an unexecuted customer limit order that it is aware of or holding; (ii) to confirm that a participant will be deemed to be holding or aware of an unexecuted customer order when the order remains unexecuted in the Matching System; and (iii) to clarify that a participant will not violate this provision if it satisfies bids and offers in other markets at a price that is better than the cross price of a customer order, in accordance with the requirements for a "cross with satisfy" order); 18 (moved from CHX Article XX, Rule 31 and modified to remove references to public bidding and offering, as on the floor of the Exchange); 19 (moved from CHX Article IX, Rule 1); 20 (combined from CHX Article IX, Rules 2 and 9; CHX Article XX, Rule 32); 21 (moved from CHX Article IX, Rule 4); 22 (combined from CHX Article IX, Rule 15 and CHX Article XX, Rule 33; modified to eliminate references to the trading floor); 23 (moved from CHX Article IX, Rule 17); and 24 (moved from CHX Article VIII, Rule 9 and modified to eliminate the definition of "Act" because that definition is already contained in CHX Article 1 of the rules).

As in CHX Article VIII, the Exchange has proposed the deletion of rules that are obsolete; that appear to be unnecessarily duplicative of existing Exchange authority or of provisions that are being retained; or that seem otherwise unnecessary for the regulation of the automated market which the Exchange will operate. For example, the Exchange proposes to delete its existing general books and records rule (CHX Article IX, Rule 7) because it has been replaced by much more detailed provisions in CHX Article 11. Similarly, the existing rule relating to the business days and hours of the Exchange (CHX Article IX, Rule 10) would be replaced by the provisions of CHX Article 20, Rule 1, which contains information (including the operating hours) associated with the Matching System's trading sessions.<sup>144</sup>

10. CHX Article 10. (Margins). The Exchange proposes to delete, from this section of its rules, the provisions relating to any margin requirements for specialists.<sup>145</sup>

11. CHX Article 11. (Books and Records). This Article is an entirely new Article that would include the four primary books and records rule that apply to Exchange participants.<sup>146</sup> Two of these proposed rules contain provisions that already appear elsewhere in the Exchange's current rules.<sup>147</sup> One new rule – CHX Rule 2 – would confirm that Exchange

---

<sup>144</sup> Other rules that would be deleted include CHX Article IX, Rule 10B (containing an obsolete rule relating to a stop order ban based on a no-longer-existing NYSE rule on the same topic); Rule 12 (containing a broad prohibition on the circulation of rumors that seems to be focused on a floor-based trading environment) and Rule 16 (relating to floor trading).

<sup>145</sup> See CHX Article 10, Rule 3(c)(6).

<sup>146</sup> The provisions in current CHX Article XI have been moved to CHX Article 7 of the proposed set of rules.

<sup>147</sup> See Proposed CHX Rule 3 (incorporating text from CHX Article XX, Rule 24) and Proposed CHX Rule 4 (moved from CHX Article V, Rule 4).

participants must make and preserve all books, accounts, records, memoranda and correspondence as required by applicable law, including Commission rules and Exchange rules. Another new rule – CHX Rule 1 – would require that participants provide the Exchange with access to books and records and must furnish requested financial and transaction-related records to the Exchange upon request. The Exchange believes that these new rules bolster the Exchange’s ability to perform its regulatory responsibilities.

12. CHX Article 12. (Disciplinary Matters and Trial Proceedings). The Exchange’s proposal would make two primary changes to this CHX Article.<sup>148</sup> First, because the Exchange would not operate a trading floor in the new trading model, the proposal would eliminate the Exchange Procedure Committee’s ability to take action against participants with respect to trading floor and other on-site decorum violations.<sup>149</sup> The proposal also would eliminate, from the Minor Rule Violation Plan, any rules that would otherwise be deleted by this proposal.<sup>150</sup>

13. CHX Article 13. (Suspensions and Reinstatements). In this Article, which previously was numbered CHX Article VII, the Exchange proposes one substantive change.<sup>151</sup>

---

<sup>148</sup> The Exchange has sought other changes to CHX Article 12, and to other Exchange rules, as part of a pending rule filing, SR-CHX-2005-06. When that proposal is approved, the Exchange will amend this submission, if necessary, to incorporate any changes arising from the other proposal.

<sup>149</sup> See CHX Article 12, deleted Rule 3.

<sup>150</sup> See e.g., CHX Article 12, Rule 8(h)(proposed deletion of rules relating to the submission of the co-specialist survey, as well as failure to comply with decorum and open outcry requirements).

<sup>151</sup> The advertising requirements of CHX Article XIII have been moved to CHX Article 8, Rule 14.

As an initial matter, the Exchange seeks to add new text that would allow the Exchange to use its emergency suspension authority whenever a participant firm that is registered as an institutional broker or market maker has failed to perform, or is failing to perform, any material responsibility imposed on the participant because of that role and, as a result, cannot be permitted to continue in business with safety to its customers or creditors or to the Exchange.<sup>152</sup> The Exchange believes that it is important to extend its suspension authority in this manner to allow the Exchange to address egregious circumstances that might arise because of an institutional broker's or market maker's failure to meet the obligations that arise because of its specialized role in the market.

14. CHX Article 14. (Arbitration). Under the Exchange's proposal, this Article would consist of Rules 23 and 24 from former CHX Article VIII. The Exchange does not propose any substantive changes to these provisions, although it has re-numbered provisions to make them somewhat more consistent with the other sets of rules.<sup>153</sup> Also, in Section 31 of Proposed CHX Rule 2, the Exchange has replaced a reference to an effective date that was "after 120 days have elapsed from the date of Commission approval of this Rule" with a reference to the appropriate specific date, January 5, 1990.

---

<sup>152</sup> See CHX Article 13, Rule 2.

<sup>153</sup> The current provisions of CHX Article XIV ("Fiscal Policies") were either transferred to CHX Article 7 ("Financial Responsibility and Reporting") or would be deleted as no longer necessary in the new trading model.

15. CHX Article 15. (Hearings and Reviews).<sup>154</sup> The Exchange currently has several disparate provisions that permit participants to seek review of an Exchange decision. These provisions often do not define the specifics associated with any hearing or review; they sometimes (but not always) permit further review by the Board. This new Article is designed to consolidate many of these provisions into one section that can be uniformly applied to Exchange decisions that do not involve disciplinary matters or appeals from arbitration decisions.<sup>155</sup>

Among other things, this new Article would provide details about requesting a hearing (which must be done within 30 days of the initial decision at issue, unless an extension of time is granted); the appointment of the hearing panel (which would be the entire Executive Committee, unless the Committee chooses to appoint a panel of five of its members to hear a matter); requesting extensions of time; submitting documents and witness lists (which ordinarily must be done at least 72 hours before the start of the hearing); the notice of hearing; the conduct of the hearing (during which all parties may be represented by counsel and the formal rules of evidence would not apply); the parameters of the decision that would be reached (for example, the decision would be in writing and ordinarily distributed within 90 days after the end of the hearing or the submission of post-hearing briefs, whichever is later); and seeking further review of the decision (which can be done by either party, within 30 days, or by the Board on its own motion).<sup>156</sup> Throughout these proposed rules, the Exchange has sought to provide a central set of

---

<sup>154</sup> The current text of CHX Article XV (“Commissions”) has either been moved to other CHX Articles (e.g., CHX Article XV, Rule 5 has been moved to CHX Article 22) or it has been deleted.

<sup>155</sup> See CHX Article 15, Rule 1.

<sup>156</sup> See CHX Article 15, Rule 2 (submission of requests for hearing); Rule 3 (requests for hearings on emergency actions); Rule 4 (hearing panel); Rule 5 (extensions of time); Rule

rules for these hearings which is similar to, but more expansive than, the various provisions scattered throughout the existing rulebook.

16. CHX Article 19. (ITS). This Article contains the ITS-related rules applicable to the Exchange's participants. The Exchange has proposed only a few changes to these rules. The most substantive change to this section of the rulebook confirms that the Exchange's Matching System will accept and execute inbound ITS commitments on behalf of its participants.<sup>157</sup> This change recognizes the much more automated nature of the trading that will occur on the Exchange in the new trading model. Other proposed changes to the rules highlight the sections that will be deleted on the effective date of the NMS Linkage Plan among various exchanges – these sections include the provisions relating to the Preopening Application, the Locked Markets requirements and the Block Trade Policy.<sup>158</sup> Other changes to the ITS rules eliminate references to the Exchange's trading floor and to rules that are being deleted as part of the implementation of the new trading model.

17. CHX Article 21. (Clearance and Settlement). In this new Article, the Exchange seeks to incorporate all of the rules that it believes would be necessary in connection with the clearance and settlement of transactions in the new trading model. These rules have been gathered from various existing CHX Articles; the section does not include any entirely new

---

6 (submissions of supporting materials); Rule 7 (notice of hearing); Rule 8 (conduct of hearing); Rule 9 (decision); and Rule 10 (seeking review of that decision).

<sup>157</sup> See CHX Article 19, Rule 1(b)(4). The proposed changes confirm that the Matching System will execute ITS commitments as set out in CHX Article 20 of the Exchange's rules.

<sup>158</sup> The Exchange will file a proposal, nearer the effective date of the NMS Linkage Plan, to formally propose the deletion of these sections.

rules, although a few rules have been modified to eliminate references to the trading floor.<sup>159</sup>

Among other things, this proposed new Article would require participants to maintain accounts with a qualified clearing agency, or with another participant that has such an account, for the recording of transactions on the Exchange.<sup>160</sup> The proposed Article would also confirm that the Exchange may extend or postpone the time for performance of contracts when required by just and equitable principles of trade or to meet unusual conditions.<sup>161</sup>

18. CHX Article 22. (Listing). This Article is numbered CHX Article XXVIII in the Exchange's current rules.<sup>162</sup> The proposed changes in this section would delete references to the Exchange's specialist firms; correct a telephone number and a typographical error; eliminate references to the Exchange's trading floor; and more accurately describe the work done by Exchange staff in connection with its surveillance of trading in exclusively listed

---

<sup>159</sup> The Exchange has updated the definition of "registered clearing agency" to confirm that it means a clearing agency which is registered with the Commission pursuant to the provisions of Section 17(A)(b)(2) of the Act or has obtained from the Commission an exemption from registration granted specifically to allow the clearing agency to provide confirmation and affirmation services. See CHX Article 21, Rule 1, Interpretation and Policy .01.

<sup>160</sup> This rule – and a related rule relating to book-entry settlement – currently are found in CHX Article XXII, Rule 3 and CHX Article XXI, Rule 4 of the Exchange's rules.

<sup>161</sup> See CHX Article 21, Rule 3 (formerly, CHX Article XXII, Rule 1). As a final matter, this provision would allow the Exchange to continue to provide services, including back-office clearing work, for participants. See CHX Article 21, Rule 4 (formerly, CHX Article XXI, Rule 13).

<sup>162</sup> The markings in this Article compare the text of CHX Article XXVIII against the proposed rule changes. The rules contained in current CHX Article XXI, which relates to the contracts, tickets and comparisons, would either be moved to other sections of the proposed new trading model rules (e.g., CHX Article XXI, Rules 4 and 13 have been moved to CHX Article 22) or would be deleted in the new trading model because the issues covered by this provision are the subject of clearing depository rules or agreements between participants and their clearing firms and/or a clearing depository.

securities.<sup>163</sup> No other changes to the Exchange's listing rules are contemplated in connection with the proposed new trading model.

19. Other deleted provisions. In addition to the changes noted in the paragraphs above, the Exchange's new trading model proposal would also eliminate the following Articles from its rulebook: CHX Article XVI (Insurance as an Ancillary Activity); CHX Article XVII (Suspension and Termination of Special Floor Registration for Unsatisfactory Performance); CHX Article XX (Regular Trading Session); XXIII (Reclamations); XXIV (Lending Securities); XXV (Closing of Contracts); XXVI (Marking to the Market); CHX Article XXIX (Special Offerings); CHX Article XXX (Specialists); CHX Article XXXI (Odd-lots); CHX Article XXXII (Exchange Distribution Plan); XXXIV (registered Market Makers – Equity Floor); CHX Article XXXV (Secondary Trading Session); CHX Article XXXVI (Baskets); and CHX Article XXXVII (Chicago Match). Each of these sets of rules would no longer be necessary in the new trading model.<sup>164</sup>

---

<sup>163</sup> See CHX Rule 23(a) (correcting the omission of the roman numeral "I"); Interpretations and Policies to Rule 23 (clarifying the work of market surveillance; deleting references to specialists; and correcting a telephone number); and CHX Rule 26 (eliminating references to the Exchange's trading floor).

<sup>164</sup> A few of these Articles contain rules for trading sessions that have been already discontinued. The Exchange, for example, is not conducting a secondary trading session under the rules set out in CHX Article XXXV and is not using the Chicago Match system described in CHX Article XXXVII. One Article, CHX Article XX, contains the rules relating to the Exchange's operation of its MAX trading system, which will be replaced with the new model's Matching System. Other Articles relate to special registration categories – such as those for odd-lot dealers (CHX Article XXXI) or specialists (CHX Article XXX) – which are not part of the new trading model. Moreover, the Exchange does not currently intend to permit special offerings (CHX Article XXIX) or use the Exchange Distribution Plan (CHX Article XXXII) or the basket rules (CHX Article XXXVI) in the new model. Finally, some of the Articles that the Exchange proposes to delete appear to be more related to clearing and settlement or to back office processes

e. **Proposed Roll-Out of New Trading Model**

The Exchange anticipates that it will be ready to begin implementing its new trading model in September 2006. Closer to the implementation date, the Exchange will notify participants of its detailed roll-out plans.

2. **Statutory Basis**

The Exchange believes that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b) of the Act.<sup>165</sup> In particular, the Exchange believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,<sup>166</sup> because it would promote just and equitable principles of trade, remove impediments to, and perfect the mechanism of, a free and open market and a national market system, and, in general, protect investors and the public interest by permitting the Exchange to operate an efficient, automated market for the trading of securities.

B. **Self-Regulatory Organization's Statement on Burden on Competition**

The Exchange does not believe that the proposed rule changes will impose any burden on competition.

---

(CHX Articles XXIII (Reclamations), XV (Closing of Contracts) and XXVI (Marking to the Market) and less related to the Exchange's on-going role as a market.

<sup>165</sup> 15 U.S.C. 78f(b).

<sup>166</sup> 15 U.S.C. 78f(b)(5).

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange has reviewed drafts of various sections of the proposed rule text, and the concept of the new trading model, with various participants. Although some participants provided varying levels of input, the Exchange did not solicit, nor did it receive, written comments with respect to this final version of the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

- (A) by order approve such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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 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-2006-05 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>167</sup>

Nancy M. Morris  
Secretary

---

<sup>167</sup> 17 CFR 200.30-3(a)(12).