

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50013; File No. SR-CHX-2004-02)

July 14, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change by The Chicago Stock Exchange, Incorporated Relating to the Minimum Automatic Execution Threshold Size

On February 11, 2004, the Chicago Stock Exchange, Inc. (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),¹ and Rule 19b-4 thereunder,² a proposed rule change to eliminate the existing 100-share minimum automatic execution threshold and the rule governing the procedures by which specialists obtain permission to switch from automatic execution mode to manual execution mode. The proposed rule change was published for comment in the Federal Register on June 10, 2004.³ The Commission received no comments on the proposal. This order approves the proposed rule change.

The Commission finds 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.⁴ Specifically, the Commission finds that the proposal is consistent with the requirements of Section 6(b) of the Act,⁵ in general, and Section 6(b)(5) of the Act,⁶ in particular, which requires that the rule of the Exchange be designed to promote just and equitable principles

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 49793 (June 2, 2004), 69 FR 32645.

⁴ In approving the proposal, the Commission has considered the rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

⁵ 15 U.S.C. 78f(b).

⁶ 15 U.S.C. 78f(b)(5).

of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Exchange has represented that under its current rules, a CHX specialist is required to permit its MAX system to automatically execute an unlimited number of orders for 100 shares or less at the then-prevailing national best bid or offer (“NBBO”), until the consolidated quotation stream reflects a change in the NBBO price. The CHX believes that this requirement imposes virtually unlimited liability on its specialists to fill orders at the NBBO regardless of the aggregate number shares actually available at the NBBO. The Exchange believes that this is an unintended and unwarranted consequence of automatic execution guarantees such as the Exchange’s current rule and that by eliminating the 100-share minimum automatic execution threshold, specialists will have the option to act as agent for an order or manually execute the order, rather than have an order execute against him automatically at the NBBO. Thus, the Commission believes that eliminating the 100-share minimum automatic execution threshold will give CHX specialists more flexibility in handling orders.

The Exchange has also represented that a number of CHX specialist firms have developed and are implementing a remote pricing functionality (“RFP”) that permits specialists to respond to orders that are dropped for manual handling. The RFP functionality permits specialists to price individual orders. The RFP then provides the Exchange’s MAX system with automated execution instructions for orders that otherwise would require further manual intervention of a CHX specialist. The Exchange believes that eliminating the 100-share minimum automatic execution threshold will grant specialists the option to handle more orders in this manner if they choose.

The Commission believes that the rule requiring specialists to guarantee automatic executions at the NBBO was one the CHX imposed on its specialists voluntarily in order to make

its market more attractive to sources of order flow. The Commission believes that the business decision to potentially forego order flow by no longer requiring specialist to provide such automatic executions is a judgment the Act allows the CHX to make. The Commission notes, however, that specialists are required to handle all orders in accordance with their best execution obligations and the Commission Quote Rule⁷ regardless of whether such orders are executed manually or automatically.

Finally, the Commission believes it is appropriate to delete the current CHX rule governing the procedures by which specialists are to obtain permission to switch from automatic execution mode to manual execution mode because the elimination of the 100-share minimum automatic execution threshold effectively permits CHX specialists to switch to manual execution mode at any time.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁸ that the proposed rule change (File No. SR-CHX-2004-02) be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁹

Margaret H. McFarland
Deputy Secretary

⁷ 17 CFR 240.11Ac1-1.

⁸ 15 U.S.C. 78s(b)(2).

⁹ 17 CFR 200.30-3(a)(12).