

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50024; File No. SR-CHX-2004-10)

July 15, 2004

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto by the Chicago Stock Exchange, Inc. Relating to Co-Specialist Assignments and Evaluations

On February 3, 2004, the Chicago Stock Exchange, Inc. (“CHX”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change relating to co-specialist assignments and evaluations. On May 12, 2004, CHX submitted Amendment No. 1 to the proposal.<sup>3</sup>

The proposed rule change, as amended, was published for notice and comment in the Federal Register on May 24, 2004.<sup>4</sup> The Commission received no comment letters on the proposal.

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange<sup>5</sup> and, in particular, the requirements of Section 6(b)(5) of the Act.<sup>6</sup> Section 6(b)(5) requires,

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

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

<sup>3</sup> See letter from Ellen J. Nelly, Senior Vice President and General Counsel, CHX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation, Commission, dated May 11, 2004 (“Amendment No. 1”). Amendment No. 1 superseded and replaced the original rule filing in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 49721 (May 18, 2004), 69 FR 29592.

<sup>5</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>6</sup> 15 U.S.C. 78f(b)(5).

among other things, that the rules of the exchange be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission notes that the proposed rule change, among other things, seeks to modify the co-specialist assignment and evaluation processes to shift the emphasis from evaluation questionnaire responses to execution quality data results (specifically, data on effective spread and speed of execution). Currently, execution quality data is not a factor for consideration during either the co-specialist assignment or evaluation processes. Instead such processes rely on the results of the co-specialist questionnaire, with substantial weight given to the questionnaire in the assignment process. Under the proposed rule change, the co-specialist questionnaire, while still a factor in the assignment process, would not be given substantial weight in the assignment process and would no longer be a factor in the evaluation process. Order execution quality data would be introduced as a factor in both the co-specialist assignment and evaluation processes and would be given substantial weight in the assignment process. The Commission believes that this change should help improve the quality of co-specialists serving on the CHX because it would require the CHX's Committee on Specialist Assignment and Evaluation ("CSAE") to make assignment and reallocation decisions based on objective, quantifiable performance criteria, rather than relying on the more subjective co-specialist questionnaire answers.

The proposed rule change also establishes a new process for evaluating co-specialists. Under this proposed evaluation process, on a quarterly basis, each co-specialist would be given an order execution quality score (derived from the execution quality data reported pursuant to

Rule 11Ac1-5 under the Act<sup>7</sup>) and those co-specialists whose scores rank in the bottom 5% of all co-specialist scores would be required to participate in a special performance meeting with the CSAE. In the course of the special performance meeting, the CSAE would be permitted to take a variety of informal actions to encourage or assist the affected co-specialist. A special performance meeting could also be triggered by any of the factors considered in the assignment process (except the co-specialist questionnaire). If the informal actions from the special performance meeting do not result in improved co-specialist performance, the CSAE may conduct a formal hearing on the co-specialist's performance to determine whether to take action to reallocate the co-specialist's securities or suspend or terminate the co-specialist's registration in accordance with Rule 3, Article XVII of the CHX rules. In this regard, the Commission notes that a co-specialist may appeal the CSAE's decision by filing a request for review with the CHX's Executive Committee under Rule 4, Article XVII of the CHX rules.

The Commission also notes that the proposed rule change strives to streamline the co-specialist questionnaire by reducing the range of rating scores and eliciting further responses for negative performance ratings. The Commission believes this change should make the questionnaires easier for brokers to complete and the responses to the questionnaires more useful to the CSAE. Therefore, the Commission finds that the proposed rule change is consistent with the Act.

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<sup>7</sup> 17 CFR 240.11Ac1-5.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>8</sup> that the proposed rule change (SR-CHX-2004-10), as amended by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>8</sup> 15 U.S.C. 78s(b)(2).

<sup>9</sup> 17 CFR 200.30-3(a)(12).