

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-50865; File No. SR-CHX-2004-03)**

**December 16, 2004**

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to Manual Execution of Orders and Amendment No. 1 Thereto**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice hereby is given that on February 11, 2004, the Chicago Stock Exchange, Incorporated (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. On December 14, 2004, the Exchange filed Amendment No. 1 to its original submission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange proposes to amend Article XX, Rule 37 of the CHX Rules, which governs, among other things, manual execution of market and marketable limit orders, to eliminate a specific requirement that a specialist execute eligible orders at the price and size associated with the national best bid or offer. The text of the proposed rule change appears below. Additions are underlined; deletions are in brackets.

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RULE 37(a). Guaranteed Executions.

1. Eligible Orders. Specialists must accept and guarantee execution of all agency market and marketable limit orders from 100 through 5099 shares in accordance with this rule.

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

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

2. Market and Marketable Limit Orders. With respect to any market or marketable limit order not executed automatically, a specialist shall use reasonable diligence to ascertain the best available price for the subject security so that the resultant execution price is as favorable to the order sender as possible under prevailing market conditions. Among the factors that will be considered in determining whether a specialist has used "reasonable diligence" are:

(a) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications; and

(b) the size and type of transaction.

[shall be obligated to either (a) manually execute such order at a price and size equal to or better than the NBBO price and size at the time the order was received; or (b) act as agent for such order in seeking to obtain the best available price for such order on a marketplace other than the Exchange, using order routing systems where appropriate. The specialist's obligation shall always be subject to the requirements of the short sale rule. For purposes of this rule, "NBBO" shall mean, for Dual Trading System issues, the size and price associated with the best bid among the American, Boston, Cincinnati, Chicago, New York, Pacific, Philadelphia or the Intermarket Trading System/Computer Assisted Execution System ("ITS/CAES") quote ("ITS Best Bid") on a sell order or the price and size associated with the best offer among the American, Boston, Cincinnati, Chicago, New York, Pacific, Philadelphia or the ITS/CAES quote ("ITS Best Offer") on a buy order (the "ITS Best Bid" and "ITS Best Offer" are collectively referred to as the "ITS BBO"). For NASDAQ/NM Securities, "NBBO" shall mean the price and size associated with the best bid disseminated pursuant to SEC Rule 11Ac1-1 on a sell order or price and size associated with the best offer disseminated pursuant to SEC Rule 11Ac1-1 on a buy order (collectively, the "NBBO"); or, if the specialist is quoting at the NBBO, the size

associated with the specialist's bid or offer and the auto-execution threshold designated by the specialist.]

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## **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 Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received regarding the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange 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**

The Exchange proposes to amend Article XX, Rule 37(a) of the CHX Rules, which governs, among other things, manual execution of market and marketable limit orders, to eliminate a specific requirement that a specialist execute orders at the price and size associated with the national best bid or offer.

#### **Background**

The CHX currently has a rule, referred to as the "BEST Rule," which sets out specific execution guarantees for eligible orders. The BEST Rule provides that, when executing orders manually, as principal, the specialist generally must execute the order at the then-prevailing BBO price up to the BBO displayed quantity, *i.e.*, the best price and liquidity available in the national

market system.<sup>3</sup> Alternatively, the specialist may elect to act as agent for the order, in which case the specialist must obtain the best available price for the order, using order-routing systems where appropriate.<sup>4</sup>

Since the securities industry conversion to decimal trading, the CHX asserts that the availability of liquidity at a BBO price point has declined, in many cases significantly. The Exchange represents that a specialist, if he chooses to offset his positions in another market, often encounters great difficulty in accessing liquidity at the BBO price that he is obligated to provide. The Exchange asserts that this is particularly true in the case of manually-executed orders, given the associated time latency and the frequency with which quotes in other markets are changing.

According to the Exchange, many CHX specialists thus believe that it is no longer appropriate to guarantee manual principal executions at the BBO price. Indeed, they believe that in today's trading environment, the BEST Rule exposes them to unwarranted liability, which they often have no ability to mitigate.<sup>5</sup> Moreover, they note, CHX order-sending firms now have

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<sup>3</sup> For Nasdaq/NM securities, the NBBO is defined as the best bid or offer disseminated pursuant to SEC Rule 11Ac1-1. For listed securities, the BBO is defined as the best bid or offer disseminated by the participants in the Intermarket Trading System Plan. See CHX Article XX, Rule 37(a)(2).

<sup>4</sup> Under the CHX's rules, orders that are executed using the CHX's automatic execution systems are executed at the BBO. See CHX Article XX, Rule 37(b).

<sup>5</sup> The CHX believes that it is important to note that under the current version of the BEST Rule, a CHX specialist acting in his principal capacity is required to execute an unlimited number of orders at the then-prevailing BBO price, up to the BBO displayed size, until the consolidated quotation stream reflects a change in the BBO price or size. As a consequence, if a large number of orders are routed to the CHX specialist simultaneously, before the consolidated quotation is updated, the CHX specialist would be obligated to fill all of the orders at the BBO price, despite the fact that the aggregate number of shares vastly exceeded the BBO size. The CHX asserts that this virtually unlimited liability is an unintended, and unwarranted, consequence of execution guarantees such as the BEST Rule.

access to comprehensive order execution quality statistics, rendering a “front-end” execution price guarantee unnecessary as a means of attracting order flow. Many CHX specialists, the Exchange contends, therefore will continue to execute orders at the BBO price voluntarily, as a means of maintaining superior execution quality statistics.

Under the proposed revision to Article XX, Rule 37(a), the specific provisions of the BEST Rule would be deleted. Instead, the specialist’s execution obligation would be described in more general terms. Under the proposed new standard, a CHX specialist would, in executing an order manually, be obligated to “...use reasonable diligence to ascertain the best available price for the subject security so that the resultant execution price is as favorable to the order sender as possible under prevailing market conditions.” Among the factors that will be considered by the Exchange’s Department of Market Regulation in determining whether a specialist has used "reasonable diligence" are: (a) the character of the market for the security, e.g., price, volatility, relative liquidity, and pressure on available communications; and (b) the size and type of transaction.<sup>6</sup>

Significantly, although this standard may appear more general in its terms, it does not remove a CHX specialist’s obligation to provide a timely best execution for each order, nor does

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For example, if the national best bid (“NBB”) was 50 x 1000 shares, the CHX specialist would be obligated to execute an unlimited number of customer sell orders at 50, as long as each order was 1000 shares or less in size, until the consolidated quotation information indicated a change in the NBB. Continuing this hypothetical example, assume that 200 sell orders, each for 100 shares, were routed to the CHX before a change in the NBB to 49 one second later. Notwithstanding the one-second pendency of the 50 NBB, the CHX specialist would be obligated to buy 20,000 shares at 50, when such liquidity at that price was not truly present anywhere in the national market system. In today’s decimal environment, such extraordinary results, which could not have been anticipated when the BEST Rule was enacted, occur often.

<sup>6</sup> The proposed new standard is substantially similar to Rule 2320 (“Best Execution”) of the National Association of Securities Dealers (“NASD”). However, the NASD has filed a proposed rule change to amend Rule 2320. See File No. SR-NASD-2004-26.

it modify any other specialist obligations set forth in Article XXX of the CHX Rules. The CHX Department of Market Regulation has indicated that it will continue its surveillance of order executions to ensure that CHX specialists meet all of their obligations to each order.

It is also important to note that the CHX rules (specifically, CHX Article XX, Rule 37(b)) would continue to require execution at the BBO price for orders that are automatically executed within the Exchange's MAX® system. The Exchange represents that there is no proposal forthcoming to modify automatic execution price guarantees.

## **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).<sup>7</sup> In particular, the proposed rule is consistent with Section 6(b)(5) of the Act in that it is designed to promote just and equitable principles 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.<sup>8</sup>

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

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

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

No written comments were either solicited or received.

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

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<sup>7</sup> 15 U.S.C. 78f(b).

<sup>8</sup> 15 U.S.C. 78f(b)(5).

Within 35 days of the date of publication of this notice in the Federal Register or within such other 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 self-regulatory organization consents, the Commission will:

- (A) by order approve the 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-2004-03 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-CHX-2004-03. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal offices of the CHX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CHX-2004-03 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>9</sup>

Margaret H. McFarland  
Deputy Secretary

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