

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51997; File No. SR-CHX-2004-17)

July 8, 2005

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto to Amend Article XX, Rule 37(a)(3) of its Rules to Eliminate Its Requirement That Specialists Guarantee Execution of Limit Orders When Certain Conditions Occur in Another Market

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 21, 2004, 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 July 5, 2005, the Exchange filed an amendment to the proposed rule change.³ 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 Exchange proposes to amend CHX Article XX, Rule 37(a)(3), which provides for execution of resting CHX limit orders based on activity in other markets, to permit, but not require, CHX specialists to guarantee execution of such limit orders when certain conditions occur in another market. The text of the proposed rule change, as amended, is available on CHX’s Web site (http://www.chx.com/marketreg/proposed_rules.htm), at CHX’s principal office, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Amendment No. 1 dated July 5, 2005, replacing the original filing in its entirety. In Amendment No. 1, the Exchange modified the text of the proposed rule change and the discussion in response to comments by the Commission staff.

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 regarding the proposal. 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 Changes

1. Purpose

The Exchange proposes to amend Article XX, Rule 37(a) of the CHX Rules, which provides for execution of resting CHX limit orders based on activity in other markets. The proposed rule change would permit, but not require, CHX specialists to guarantee execution of such limit orders when certain conditions occur in another market.

Background

CHX Article XX, Rule 37(a)(3) sets out specific execution guarantees for eligible limit orders. For listed issues, the rule generally obligates a CHX specialist to guarantee execution of limit orders resting in the specialist’s book, when the issue is being traded in the primary market at a price equal to or better than the limit price. For NASDAQ/NM securities, the rule permits, but does not require, a CHX specialist to guarantee execution of limit orders resting in the specialist’s book, when another market center’s quotation locks or crosses the limit price.

The guarantees set forth in CHX Article XX, Rule 37(a)(3), commonly referred to as “limit order protection” or “primary market protection,” were adopted voluntarily by the CHX over 15 years ago, as a means of attracting order flow. As noted by the Commission, the

Exchange's initiatives relating to primary market protection were intended to ensure "... fair competition among exchange markets, which benefits public investors."⁴

Industry Changes Since Adoption of the Execution Guarantees

As our industry has evolved, the Exchange's principal competitors for order flow, namely "third market" execution venues and alternative trading systems, do not provide such limit order protection guarantees. Accordingly, the Exchange believes that the guarantees no longer serve a clear competitive purpose. This is particularly the case in recent years, since CHX order-sending firms now have free access to comprehensive monthly order execution quality statistics, rendering "front-end" execution guarantees unnecessary as a means of attracting order flow. Firms are able to closely monitor execution quality and, thereby, ensure that they are meeting their best execution obligations, without relying on rule-based guarantees.⁵

Compounding the lack of competitive value, the guarantees currently subject CHX specialists to exposure that was never intended when the rule-based guarantees were enacted. Since the securities industry conversion to decimal trading, the availability of liquidity at a best bid or offer ("BBO") price point has declined, in many cases significantly. The CHX specialist,

⁴ See Securities Exchange Act Release No. 32124 (April 13, 1993), 58 FR 21325 (April 20, 1993). The Exchange believes that other regional exchanges have enacted similar rule-based guarantees. See, e.g., BSE Chapter II, Section 33, Interpretation and Policy .01, NSX Rule 11.9, and Phlx Rule 229. The Exchange believes that the rule-based guarantees were enacted on a strictly voluntary basis and were not required by the Act or by any requirement promulgated by Congress or the Commission in accordance with the Act, including the Order Handling Rules issued by the Commission in 1996. See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996). The standards for execution of limit orders set forth in the Order Handling Rules do not require that best execution be measured on an order-by-order basis. Rather, they contemplate evaluation using aggregate standards.

⁵ The Exchange notes the dramatic increase in market share that has been achieved by several of the Exchange's third market competitors as evidence that order-sending firms no longer consider rule-based execution guarantees essential to their order-routing decisions, or presumably to satisfaction of their best execution obligations.

if he chooses to offset his positions in another market, often encounters great difficulty in accessing liquidity at the price that he is obligated to provide. 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.

Many CHX specialists, thus, believe that it is no longer appropriate to mandate that specialists guarantee execution of resting limit orders for listed issues, based on activity in other market centers. Indeed, they believe that in today's trading environment, the limit order execution guarantee exposes them to unwarranted liability, which they often have limited ability to mitigate.⁶

In short, the CHX believes that the environment has changed significantly since it voluntarily enacted its rule-based execution guarantees, warranting the amendments proposed by the CHX. The CHX believes that the guarantees no longer foster significant competition between markets. Absent this benefit to investors, the Exchange believes that there is no legal basis for continuing to mandate such guarantees, which, as discussed above, are not required under the Act or other requirements promulgated by Congress or the Commission. Accordingly, the Exchange believes that it is appropriate to render such guarantees voluntary, on the terms outlined below.

Proposed Rule Change

Under the proposed revision to CHX Article XX, Rule 37(a)(3), the mandate that CHX specialists guarantee execution of resting limit orders for listed issues, based on triggering

⁶ In fact, the exposure of a CHX specialist exceeds that of a specialist on the primary market, whose best execution obligation effectively requires only that he guarantee a limit order execution, if another market executes an order at a price better than the limit price. Under the current CHX rule, the CHX specialist is required to execute a limit order, if the primary market executes an order at the limit price.

activity in other markets, would be deleted. Instead, the amended rule would permit CHX specialists to continue to provide such guarantees solely on an issue-by-issue basis, on non-discriminatory terms approved by the Exchange. The Exchange's existing functionality providing for automated execution of resting limit orders would remain available for CHX specialists who elect to continue to guarantee limit order protection.⁷

Significantly, deletion of the rule-based mandate regarding limit order protection would not remove a CHX specialist's obligation to provide a timely best execution for each order, nor would it modify any other specialist obligations set forth in CHX Article XXX of the CHX Rules. The CHX Department of Market Regulation would continue its surveillance of order executions to ensure that CHX specialists meet all of their obligations to each order.

Accordingly, many CHX specialists would continue to execute resting limit orders for listed issues voluntarily, when quotes or executions at the limit price occur in other markets, as a means of satisfying their best execution obligations and maintaining superior execution quality statistics.

2. Statutory Basis

The Exchange believes that the proposal, as amended, 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.⁸ Specifically, the CHX believes that the proposal, as amended, is consistent with Section 6(b)(5) of the Act,⁹ in

⁷ The Exchange anticipates that for the foreseeable future, CHX specialists would continue to provide limit order protection voluntarily, using the criteria for voluntary limit order protection currently set forth in CHX Article XX, Rule 37(a)(3). To the extent that the Exchange approved some variation in the limit order protection criteria, the Exchange would notify all CHX participants of this change.

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

that it is 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.

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

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

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

No written comments were either solicited or received.

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

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. Please include File Number SR-CHX-2004-17 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File No. SR-CHX-2004-17. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office 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 No. SR-CHX-2004-17 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.¹⁰

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Assistant Secretary

¹⁰ 17 CFR 200.30-3(a)(12).