

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52534; File No. SR-CHX-2004-25)

September 29, 2005

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1, 2, and 3 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 4 Thereto Relating to a Prohibition on Using a Layoff Service Unless the Service Provides Required Information to the Exchange

I. Introduction

On August 31, 2004, the Chicago Stock Exchange, Inc. (“CHX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend CHX Article V, Rule 4 to prohibit CHX participants from using any communications means to send orders to another market for execution (a “layoff service”), unless the layoff service has established a process for providing the Exchange with specific information about the orders and the executions that participants receive. On June 7, 2005 and June 27, 2005, the Exchange filed Amendment Nos. 1³ and 2⁴ to the proposed rule change, respectively. The proposed rule change, as amended by Amendment Nos. 1 and 2, was

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Amendment No. 1 dated June 7, 2005. In Amendment No. 1, the Exchange, among other things, added a requirement for participants to provide additional information about their layoff activity; replaced references to the Exchange’s “members” with references to its “participants” to reflect changes in terminology associated with the Exchange’s February 2005 demutualization; required that participants notify the Exchange before using an alternative or additional layoff vendor; and confirmed that these rules would not replace any record retention obligations to which the Exchange’s participants would be subject under the Act and the rules thereunder.

⁴ See Amendment No. 2 dated June 27, 2005, replacing the original filing and Amendment No. 1 in their entirety. In Amendment No. 2, the Exchange eliminated the requirement to provide information about the contra party to the execution and made other technical changes to the proposal.

published for comment in the Federal Register on July 12, 2005.⁵ The Commission received no comments on the proposal, as amended by Amendment Nos. 1 and 2. On August 12, 2005, the CHX filed Amendment No. 3 to the proposed rule change.⁶ Amendment No. 3 was published for notice and comment in the Federal Register on August 18, 2005.⁷ The Commission received no comments on Amendment No. 3. On September 23, 2005, the CHX filed Amendment No. 4 to the proposed rule change.⁸ This order approves the proposed rule change, as amended by Amendment Nos. 1, 2, and 3; grants accelerated approval to Amendment No. 4 of the proposed rule change; and solicits comments from interested persons on Amendment No. 4.

II. Description of the Proposal

The Exchange's proposal, which would amend the Exchange's rule relating to communications from the trading floor, is designed to provide the Exchange with the layoff service information that it needs to enhance its surveillance programs. Specifically, the proposal would prohibit Exchange participants, beginning on September 30, 2005 for Dual Trading System issues⁹ and October 31, 2005 for NASDAQ/NM securities,¹⁰ from using a layoff service

⁵ See Securities Exchange Act Release No. 51967 (July 1, 2005), 70 FR 40086.

⁶ See Amendment No. 3 dated August 12, 2005. In Amendment No. 3, which supplemented the proposal as noticed, the CHX modified the proposed rule text to eliminate the reference to an August 1, 2005 effective date and instead provided for an effective date of September 30, 2005.

⁷ See Securities Exchange Act Release No. 52248 (August 12, 2005), 70 FR 48610.

⁸ See Amendment No. 4 dated September 23, 2005. In Amendment No.4, the Exchange amended the proposed rule to include a new effective date of October 31, 2005 for NASDAQ/NM securities in order to allow its participants and their layoff vendors additional time to implement system changes to comply with the proposed rule change. The effective date for Dual Trading System issues would remain at September 30, 2005. The Commission notes that under the Exchange's rules, Dual Trading System securities are securities listed on the New York Stock Exchange, Inc., the American Stock Exchange, Inc., or on markets other than the Nasdaq Stock Market, Inc. that are also listed or traded on the CHX.

⁹ See Amendment No. 3, supra note 6.

to send orders to another market for execution, unless that service (or the participant using the service) has established a process for providing the Exchange with the following specific information: (1) the symbol of the security to be traded; (2) the clearing organization; (3) an order identifier that uniquely identifies the order; (4) the participant recording the order details; (5) the number of shares; (6) the side of the market on which the order is placed; (7) a designation of the order type (e.g., market, limit, stop, stop limit); (8) whether the order is for the account of a customer or for the account of the participant sending the order; (9) whether the order is short or short exempt; (10) any limit price and/or stop price; (11) the date and time of order transmission; (12) the market to which the order was transmitted; (13) the time in force; (14) a designation of the order as held or not held; (15) any special conditions or instructions associated with the order (including any customer do-not-display instructions or all-or-none conditions); (16) any modifications to the details set out in (1) through (15) for all or part of an order or any cancellation of all or part of the order; (17) the date and time of the transmission of any modifications to the order or any cancellation of the order; (18) the date and time of any order expiration; (19) the identification of the party canceling or modifying the order; (20) the transaction price; (21) the number of shares executed; (22) the date and time of execution; (23) settlement instructions; (24) a system-generated time(s) of recording the required information; and (25) any other information that the Exchange may require from time to time.¹¹ For purposes of this proposal, an “order” would be defined as any written, oral or electronic instruction to effect a transaction.¹²

¹⁰ See Amendment No. 4, supra note 8.

¹¹ See proposed CHX Article V, Rule 4, Interpretation and Policy .01.

¹² See proposed CHX Article V, Rule 4, Interpretation and Policy .03.

Other provisions of the proposal set out additional requirements that are designed to ensure that the Exchange receives uniformly-presented, useful data. For example, the Exchange proposes that all information be provided on a real-time basis and in an electronic format acceptable to the Exchange.¹³ In addition, each layoff service would be required to synchronize its business clocks and maintain that synchronization, with all time references expressed in terms of hours, minutes, and seconds.¹⁴

In addition, the proposal provides that a violation of the proposed new requirements would be considered conduct inconsistent with just and equitable principles of trade, in violation of CHX Article VIII, Rule 7.¹⁵ Therefore, these violations would not be eligible for handling under the Exchange's Minor Rule Violation Plan. The Exchange would also prohibit a participant from using an alternative or additional layoff vendor, unless it has notified the Exchange of the change.¹⁶ The Exchange confirms in its rule that the provisions in proposed CHX Article V, Rule 4 would not replace any record retention obligations to which the Exchange's participants could be subject under the Act and rules thereunder.¹⁷ Finally, as an administrative matter, the Exchange also proposes to delete CHX Article V, Rule 5, which applied to wires from the Exchange's floor to its branch offices, since the Exchange represents that it no longer maintains branch offices and has no purpose for keeping this rule in place.

¹³ See proposed CHX Article V, Rule 4, Interpretation and Policy .01.

¹⁴ See proposed CHX Article V, Rule 4, Interpretation and Policy .02 and .03.

¹⁵ See proposed CHX Article V, Rule 4, Interpretation and Policy .04.

¹⁶ See proposed CHX Article V, Rule 4, Interpretation and Policy .05.

¹⁷ See proposed CHX Article V, Rule 4, Interpretation and Policy .06.

III. Discussion and Commission Findings

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹⁸ In particular, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,¹⁹ which requires that the rules of an 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 Exchange typically obtains information about off-floor activity of its participants from the Regional Exchange Data Summary (“REDS”) data provided by the Securities Industry Automation Corporation. However, according to the Exchange, the REDS data did not attribute layoff activity to the particular CHX member who transmitted a layoff order. Instead, Exchange market regulation analysts had to manually review the Exchange’s exception reports and other trading records in order to conduct surveillance specific to individual CHX participants.²⁰ CHX has stated that the recording of layoff order information directly from the systems providers will eliminate this manual step, and that the proposal will provide it with necessary layoff service information to enhance its surveillance system.

¹⁸ In approving this proposed rule change, as amended, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁹ 15 U.S.C. 78f(b)(5).

²⁰ See Letter from David C. Whitcomb, Jr., Senior Vice President and Chief Regulatory Officer, CHX, to Sharon Lawson, Senior Special Counsel, Division of Market Regulation, Commission, dated March 16, 2005 (discussing, in general, how the Exchange plans to utilize the data to be gathered pursuant to the proposed rule change).

The Exchange's proposed rule change is intended to address recommendations made in the Exchange's 2003 settlement agreement with the Commission.²¹ In the settlement agreement, the Commission cited the Exchange's failure "to detect and prevent a large number of trading rule violations, in part, because [the Exchange] did not have adequate surveillance systems to detect possible violations."²² In addition, the Commission found that the CHX had "relied on ineffective and often flawed manual processes to detect violations."²³ The Commission believes that the Exchange's proposed obligations on its participants to use only layoff services that can provide specific, designated order information to the CHX is consistent with the recommendations made in the Exchange's settlement agreement with the Commission.

Specifically, the Commission believes that the proposed rule change, as amended, will provide the Exchange with a more automated process for receiving a comprehensive set of audit trail data on CHX participants' trading activity conducted through layoff systems.²⁴ The proposal will permit the Exchange to more efficiently collect information on the off-floor activity of CHX participants, thereby allowing the Exchange to integrate the audit trail data into its surveillance systems. Increased automation with respect to the receipt of layoff order details will, in turn, allow the Exchange to perform more automated surveillance and generate better surveillance reports.

²¹ See Securities Exchange Act Release No. 48566 (September 30, 2003) (Administrative Proceeding File No. 3-11282), available at: <http://www.sec.gov/litigation/admin/34-48566.htm>.

²² Id.

²³ Id.

²⁴ The Exchange represents that layoff systems are private order routing networks which provide connectivity and order management functionality for orders sent to the primary exchanges in the listed markets. See supra note 20.

In addition, the Commission believes that the proposal will improve the Exchange's ability to review its members' order-handling activities and to determine their compliance with applicable trading rules. For example, the Exchange's receipt of layoff vendor data will enhance the Exchange's review of specialists' compliance with the limit order display rule,²⁵ short sale position marking and tick text requirements,²⁶ best execution,²⁷ and trading ahead prohibitions.²⁸

Based on the above, the Commission finds the Exchange's efforts, through the proposed rule change, to enhance its surveillance of these areas with respect to layoff orders to be consistent with recommendations made in the Exchange's settlement agreement with the Commission.²⁹ Further, the Commission finds that the Exchange's proposal to enhance surveillance for compliance with CHX's rules, the Act and the rules thereunder is consistent with the requirements of Section 6(b)(5) of the Act,³⁰ which requires that the rules of an exchange be designed to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.³¹ The Commission emphasizes that the detailed information required to be obtained relating to the layoff service will not replace any record retention obligations already required of CHX participants under the Act and the rules thereunder.

In summary, the Commission believes that approving the proposal will help to strengthen the Exchange's surveillance program by providing the Exchange with data necessary to

²⁵ See 17 CFR 240.11Ac1-4 and CHX Article XX, Rule 7.05.

²⁶ See 17 CFR 240.10a-1.

²⁷ See CHX Article XX, Rule 37.

²⁸ See CHX Article XXX, Rules 2 and 3.

²⁹ See *supra* note 21.

³⁰ 15 U.S.C. 78f(b)(5).

³¹ As an additional matter, the Commission believes that the proposal to delete CHX Article V, Rule 5 that applied to wires from the Exchange's floor to its branch offices is reasonable since the Exchange represents that it no longer maintains branch offices.

appropriately conduct more thorough and efficient surveillance of its participants' trading activities.³²

Accelerated Approval of Amendment No. 4

The Commission finds good cause for approving Amendment No. 4 to the proposed rule change prior to the thirtieth day after the amendment is published for comment in the Federal Register pursuant to Section 19(b)(2) of the Act.³³ Amendment No. 4 revises the proposed implementation date of the proposed rule change to October 31, 2005 for NASDAQ/NM securities, and maintains the implementation date for Dual Trading System issues at September 30, 2005. The Commission believes that the proposed extension of the compliance date for NASDAQ/NM securities to October 31, 2005 is reasonable in order to allow CHX participants and their layoff vendors additional time to implement system changes to comply with the proposal, while, at the same time, allows the Exchange to implement the proposal immediately, as of September 30, 2005, for Dual Trading System issues without further delay. Accordingly, the Commission believes that accelerated approval of Amendment No. 4 is appropriate.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether Amendment No. 4 to the proposed rule change 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

³² In a related proposed rule change, the Exchange proposes to amend its rules to require its on-floor participants to maintain specific details about orders originating on or off the floor of the Exchange for execution on the Exchange, as well as orders issued from the floor of the Exchange to any other market or trading venue. See SR-CHX-2004-38, available at: http://www.chx.com/rules/proposed_rules.htm.

³³ 15 U.S.C. 78s(b)(2).

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-CHX-2004-25 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-CHX-2004-25. 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 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-2004-25 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

V. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,³⁴ that the proposed rule change (SR-CHX-2004-25) and Amendment Nos. 1, 2, and 3 thereto are approved, and that Amendment No. 4 thereto is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁵

Jonathan G. Katz
Secretary

³⁴ 15 U.S.C. 78s(b)(2).

³⁵ 17 CFR 200.30-3(a)(12).