SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50481; File No. SR-CHX-2004-12)

September 30, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1
Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendments No. 2
and 3 to the Proposed Rule Change by the Chicago Stock Exchange, Inc. Relating to the
Implementation of a Fully-Automated Functionality for the Handling of Particular Orders Called
CHXpress

I.   Introduction

On February 20, 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 XX, Rule 37 to implement a new automated functionality for

handling particular orders called CHXpress. On April 8, 2004, the Exchange amended the

proposed rule change.[3] The proposed rule change, as amended by Amendment No. 1, was

published for comment in the Federal Register on April 21, 2004.[4] The Commission received no

comments on the proposed rule change, as amended. On May 11, 2004 and August 23, 2004, the

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[1]   15 U.S.C. 78s(b)(1).

[2]   17 CFR 240.19b-4.

[3]   See letter from Ellen J. Neely, Senior Vice President and General Counsel, CHX, to
        Nancy J. Sanow, Assistant Director, Division of Market Regulation ("Division"),
        Commission, dated April 7, 2004, and the attached Form 19b-4, which replaced the
        original filing in its entirety ("Amendment No. 1").

[4]   See Securities Exchange Act Release No. 49567 (April 15, 2004), 69 FR 21591.

Exchange filed Amendments No. 2 and 3 to the proposed rule change, respectively.[5] This order

approves the proposed rule change, as amended, grants accelerated approval to Amendments No.

2 and 3, and solicits comments from interested persons on Amendments No. 2 and 3.

II.   Description of the Proposed Rule Change

The Exchange proposes to implement a new automated functionality built into the

Exchange's MAX® system called CHXpress for certain orders.[6] Under the proposal, only

unconditional, round-lot limit orders could be designated as CHXpress orders.[7] CHXpress

orders could be submitted in an issue only after an order has been executed on the primary

market in that issue and would be automatically cancelled at the end of each trading day, if they

remain unexecuted.[8]

CHXpress orders could be routed into the MAX system by the Exchange's order-sending

firms or by CHX floor brokers. All orders would be required to be specifically designated as

CHXpress orders to ensure appropriate handling in the Exchange's automated systems.[9] Under

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[5]   See letters from Ellen J. Neely, Senior Vice President and General Counsel, CHX, to
         Nancy J. Sanow, Assistant Director, Division, Commission, dated May 10, 2004
         ("Amendment No. 2") and August 20, 2004 ("Amendment No. 3"). In Amendment No.
         2, the Exchange made technical corrections to the text of the proposed rule change. In
         Amendment No. 3, the Exchange changed the designator that would identify CHXpress
         orders in the Exchange's MAX system from "E" to "XPR," provided additional detail
         regarding the handling of CHXpress orders during a trading halt, and confirmed that the
         Exchange would automatically cancel both inbound orders and orders already in the
         book, if the execution of the order would improperly trade through another Intermarket
         Trading System ("ITS") market or if the display of the order would improperly lock or
         cross another ITS market.

[6]   The MAX system provides automated display and execution for orders sent to the
         Exchange's specialists for execution.

[7]   See CHX Article XX, Rule 37(b), proposed section 11(A).

[8]   Id.

[9]   See CHX Article XX, Rule 37(b), proposed section 11(A), and Amendment No. 3, supra
         note 5.

the proposal, CHXpress orders would be executed immediately and automatically against same

or better-priced orders in the specialist's book, or against the specialist, unless those executions

would trade through another ITS market or unless trading in the issue has been halted.[10]

If a CHXpress order could not be immediately executed, it would be placed in the

specialist's book for instantaneous display or later execution.[11] However, CHXpress orders, like

all other orders at the Exchange, would not be eligible for automated display if that display

would improperly lock or cross another ITS market.[12] In such instances, the CHXpress order

would be automatically cancelled.

Finally, under the proposed rules, CHXpress orders would be primarily designed to

match against orders in the specialist's book.[13] As a result, CHX specialists would not provide

CHXpress orders with the execution guarantees that might otherwise be available to agency limit

orders.[14] Specifically, these orders would not be eligible for automated price improvement, or

execution based on quotes in the national market system or prints in the primary market for a

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[10] If the execution of a CHXpress order would cause an improper trade-through of another ITS market, the CHXpress order would be automatically cancelled. See CHX Article XX, Rule 37(b), proposed section (11)(C), and Amendment No. 3, supra note 5. If trading in an issue has been halted, all CHXpress orders in that issue would be automatically cancelled. The Exchange would not accept any CHXpress orders in an issue during a trading halt and would not resume accepting such orders until an execution has occurred in the primary market. Id.

[11] A CHXpress order would be instantaneously and automatically displayed when it constitutes the best bid or offer in the CHX book. See CHX Article XX, Rule 37(b), proposed section 11(D).

[12] The Exchange's MAX system does not permit the automatic display of any order greater than 100 shares where that order would lock or cross another ITS market.

[13] A specialist could participate in filling a CHXpress order, but could not do so if that execution would cause the specialist to trade ahead of any other order in the book.

[14] See CHX Article XX, Rule 37(b), proposed sections 11(E) and (F).

security.[15] CHX specialists also would not act as agent for the orders in other markets. CHX

specialists, however, would be required to integrate their handling of CHXpress orders with any

executions that occur at the post with floor brokers or market makers.[16]

III. Discussion

After careful review, 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.[17] In particular, the Commission finds that the proposed rule

change, as amended, is consistent with Section 6(b)(5) of the Act[18] in 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.

As noted by the Exchange, CHXpress orders will automatically and immediately execute

against orders in the specialist's book or against the specialist unless the execution would cause a

trade through of another ITS market or trading has been halted in the particular security. The

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[15] Under the Exchange's existing rules, a specialist can engage an automated functionality in the MAX system to provide price improvement to eligible agency orders and can use automated functionalities to provide agency orders with protection against trades in the primary market for both listed and Nasdaq/NM securities. See CHX Article XX, Rule 37(d) (describing the SuperMAX price improvement functionality) and Rule 37(a)(3) (setting out the limit order protections otherwise guaranteed to limit orders, such as protections against primary market trades at or through a limit order's price).

[16] For example, if the specialist is in the process of manually executing an order on the floor at the displayed bid, and a CHXpress order automatically executes against that bid before the specialist is able to complete the transaction on the floor, the specialist would still be required to honor the trade on the floor at the displayed bid price, even if that displayed interest is no longer available. See CHX Article XX, Rule 37(b), proposed section 11(G).

[17] In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

[18] 15 U.S.C. 78f(b)(5).

Commission believes that this new automatic execution system should provide investors with an efficient mechanism by which to immediately interact with the Exchange's quote and allow investors to immediately access liquidity on the Exchange.

Moreover, the Commission believes that the proposal, as amended, will provide investors with additional order routing capabilities that may enhance the execution of their orders. The proposal provides a new execution facility in addition to the current execution facilities on the CHX. Investors will be able to choose a more immediate execution that will not provide them with price improvement opportunities on CHXpress or choose to direct their order to the current CHX BEST or MAX system for price improvement opportunities. The Commission finds that allowing the automatic execution of CHXpress orders against orders in the specialist's book will help to perfect the mechanism of a free and open market by providing an execution vehicle for investors who value immediate and automatic access to available liquidity at the Exchange more than the opportunity for price improvement.[19]

Furthermore, the Commission believes that the Exchange's proposal to automatically cancel and not accept any CHXpress orders in an issue during a trading halt, and cancel both inbound orders and orders already in the book if the execution of the order would improperly trade through another ITS market will protect investors and promote the fair and orderly operation of the markets. Specifically, the Commission believes these proposed rules will increase the efficiency of the Exchange's order routing and execution system and enable market

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[19] The Commission notes, however, that while it believes that the proposed rule change, as amended, is consistent with the requirements of the Act, the Commission is not making a determination that the CHX's automatic execution capabilities would satisfy the "automated order execution facility" definition in Rule 600(b)(3) of proposed Regulation NMS. See Securities Exchange Act Release No. 49325 (February 26, 2004), 69 FR 11126 at 11203 (March 9, 2004). See also Securities Exchange Act Release No. 49749 (May 20, 2004), 69 FR 30142 (May 26, 2004).

participants to make informed order entry decisions based on current, disseminated information regarding the issue.

Application of "Effect v. Execute" Exemption from Section 11(a) of the Act

Section 11(a) of the Act[20] prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, "covered accounts") unless an exception applies. In addition to the exceptions set forth in the statute, Rule 11a2-2(T)[21] provides exchange members with an exemption from this prohibition. Known as the "effect versus execute" rule, Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions on the exchange. To comply with the rule's conditions, a member (i) must transmit the order from off the exchange floor; (ii) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;[22] (iii) may not be affiliated with the executing member; and (iv) with respect to an account over which the member has investment discretion, neither the member nor its associated person may retain any compensation in the connection with effecting the transaction except as provided in the Rule.

In a letter dated July 6, 2004,[23] the CHX represents that transactions effected using the CHXpress functionality satisfy the conditions of Rule 11a2-2(T). Based on these

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[20]   15 U.S.C. 78k(a).

[21]   17 CFR 240.11a2-2(T).

[22]   The member, however, may participate in clearing and settling the transaction.

[23]   See letter from Ellen J. Neely, Senior Vice President and General Counsel, CHX, to Katherine England, Assistant Director, Division, Commission, dated July 6, 2004.

representations, the Commission finds that the CHXpress functionality complies with the

requirements of Section 11(a) of the Exchange Act and Rule 11a2-2(T) thereunder.[24]

First, according to the CHX, all CHXpress orders would be electronically submitted

either by members from locations off the exchange floor or by floor brokers located on the

Exchange floor for the accounts of off-floor members. Specifically, floor brokers may receive an

order, by telephone, from an off-floor member not affiliated with the floor broker. Thereafter,

the floor broker may decide that it would be best to execute all or a portion of the off-floor

member's order in CHXpress. Accordingly, because the off-floor member submitted its order to

an unaffiliated floor broker on the floor from off the Exchange floor, the Commission believes

that it has satisfied the off-floor transmission requirement. Second, because a member would

relinquish control of its order after it is submitted to CHXpress and would not be able to

influence or guide the execution of its order, the member would not be participating in the

execution of its order. Third, although the rule contemplates having an order executed by an

exchange member who is not affiliated with the member initiating the order, the Commission

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[24] The Commission and its staff, on numerous occasions, have considered the application of Rule 11a2-2(T) to electronic trading and order routing systems. See, e.g., Securities Exchange Act Release Nos. 49068 (January 13, 2004) (Order approving the Boston Options Exchange as an options trading facility of the Boston Stock Exchange); 44983 (October 25, 2001) (Order approving the Archipelago Exchange as the equities trading facility of PCX Equities Inc.); 29237 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); 15533 (January 29, 1979) (regarding the Amex Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX's Communications and Execution System, and the Phlx's Automated Communications and Execution System); and 14563 (March 14, 1978) (regarding the NYSE's Designated Order Turnaround System). See also letter from Larry E. Bergmann, Senior Associate Director, Division, Commission, to Edith Hallahan, Associate General Counsel, Phlx (March 24, 1999) (regarding Phlx's VWAP Trading System); letter from Catherine McGuire, Chief Counsel, Division, Commission, to David E. Rosedahl, PCX (November 30, 1998) (regarding Optimark); and letter from Brandon Becker, Director, Division,

recognizes that this requirement is satisfied when automated exchange facilities are used.[25]

Fourth, the CHX states that members that rely on Rule 11a2-2(T) for a managed account

transaction would be required to comply with the limitations on compensation set forth in the

rule.

Accelerated Approval of Amendments No. 2 and 3

The Commission finds good cause to approve Amendments No. 2 and 3 to the proposed

rule change prior to the thirtieth day after the amendments are published for comment in the

Federal Register pursuant to Section 19(b)(2) of the Act.[26] Amendment No. 2 made technical

corrections to the proposed rule text. Amendment No. 3 also made technical corrections to the

proposed rule text and addressed concerns raised by the Commission staff by clarifying in the

proposed rule text how CHXpress orders would be handled during a trading halt, and confirming

that, if an execution of a CHXpress order in the book would cause an improper trade-through of

another ITS market or if the display of the order would improperly lock or cross another market,

the Exchange would automatically cancel both inbound orders and orders already in the book.

The Commission believes that the proposed changes in Amendments No. 2 and 3 provide a

clearer understanding of the operation of the CHXpress functionality and raise no new issues of

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Commission, to George T. Simon, Foley & Lardner (November 30, 1994) (regarding Chicago Match).

[25]   In considering the operation of automated execution systems operated by an exchange, the Commission noted that while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems. Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T). See Securities Exchange Act Release No. 15533 (January 29, 1979).

[26]   15 U.S.C. 78s(b)(2).

regulatory concern and, therefore, believes good cause exists to accelerate approval of Amendments No. 2 and 3.

IV.   Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 2 and 3, including whether Amendments No. 2 and 3 are 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-2004-12 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-2004-12. 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 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 Number SR-CHX-2004-12 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 Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with Section 6(b)(5) of the Act.[27]

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[28] that the proposed rule change (SR-CHX-2004-12) and Amendment No. 1 thereto are approved, and that Amendments No. 2 and 3 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[29]

Margaret H. McFarland
Deputy Secretary

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[27]   15 U.S.C. 78f(b)(5).

[28]   15 U.S.C. 78s(b)(2).

[29]   17 CFR 200.30-3(a)(12).