SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–46760; File No. SR–CHX–2002–31]

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Chicago Stock Exchange, Inc. Relating to Execution of Limit Orders Following Exempted ITS Trade-Through

November 1, 2002.

I. Introduction

On September 20, 2002, the Chicago Stock Exchange, Inc. (''CHX'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''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 render voluntary a CHX specialist's obligation to fill limit orders in the specialist's book following a primary market trade-through, if such trade-through occurs in an exchange-traded funds (''ETFs'') tracking the Nasdaq–100 Index (''QQQs''), the Dow Jones Industrial Average (''DIAMONDs''), and the Standard & Poor's 500 Index (''SPDRs'').

The proposed rule change was published for comment in the **Federal Register** on October 2, 2002.[3] No comments were received on the proposal. This order approves the proposal.

II. Description of the Proposal

A. Background

The CHX is a participant in the Intermarket Trading System (''ITS''). The ITS is an order routing network designed to facilitate intermarket trading in exchange-listed equity securities among participating self-regulatory organizations (''SROs'') based on current quotation information emanating from their markets. The terms of the linkage are governed by the ITS Plan, a national market system plan approved by the Commission pursuant to Section 11A of the Act and Rule 11Aa3–2 thereunder.[4]

Section 8(d)(i) of the ITS Plan provides that absent reasonable justification or excuse, a member of a Participant Exchange should not effect trade-throughs.[5] If, however, a trade-through does occur and a complaint is received through ITS from the party whose bid or offer was traded through, the party who initiated the trade-through may be required to satisfy the bid or offer traded through or take other remedial action.[6] Each Participant Exchange, including the Phlx,[7] has adopted and obtained Commission approval of a ''trade-through rule,'' which is substantively the same as that provided in the ITS Plan.

In a recent Order, the Commission recognized that the ITS trade-through provisions were designed to encourage market participants to display their trading interest, and to help achieve best execution for customer orders in exchange-listed securities.[8] The Commission also acknowledged, however, that these rules were designed at a time when ''the order routing and execution facilities of markets were much slower, intermarket competition was less keen, and the minimum quote increment for exchange-listed securities was ⅛ of a dollar ($ 0.125).'' [9] The Commission noted that with the introduction of decimal pricing and technology changes that greatly reduced execution times, the trade-through provisions of the ITS Plan have limited the ability of a Participant to provide an automated execution when a better price is displayed by another Participant that does not offer automated executions.[10] In support of this conclusion, the Commission explained that certain electronic systems are able to deliver executions in a fraction of a second, while ITS participants have, at a minimum, thirty seconds to respond to a commitment to trade. Because of this, ''an ITS Participant seeking to execute a transaction at a price inferior to the price quoted by another ITS Participant must generally either (i) attempt to access the other Participant's quote, which could delay the customer's transaction by thirty seconds or more, or (ii) become potentially liable to the other Participant for the amount by which its quote was traded through.'' [11]

In its Order, the Commission stated that the ITS trade-through provisions were particularly restrictive in the case of the QQQs, DIAMONDs and SPDRs, as these ETFs are highly liquid securities, and their value is derived from the values of the underlying shares. The Commission noted that immediate execution of these securities might be more important than the opportunity to obtain a better price to certain investors.[12] To address this issue, the Commission granted a *de minimis* exemption from the trade-through provisions of the ITS Plan with respect to transactions in the QQQs, DIAMONDs and SPDRs that are effected at a price no more than three cents away from the best bid and offer quoted in the Consolidated Quote System (''CQS''). This exemption, which went into effect on September 4, 2002 and will remain in effect until June 4, 2003, allows Participants to execute transactions, through automatic execution or otherwise, without attempting to access the quotes of other Participants when the expected price improvement would not be significant.[13]

B. Applicability to the CHX

CHX Article XX, Rules 37(a)(3) and 37(b)(6) govern the execution of limit orders in a CHX specialist's book. Specifically, these rules require a CHX specialist to fill limit orders in his book if there is a trade-through of the limit price in the primary market. The CHX specialist, in turn, is entitled to seek satisfaction for these orders pursuant to the ITS Plan's provisions governing trade-throughs.

However, pursuant to the Commission's ITS Exemption Order, certain primary market trade-throughs in the QQQs, DIAMONDS and SPDRs that would trigger a CHX specialist's obligation to provide trade-through protection will now be permitted, and thus will leave the CHX specialist without recourse to seek satisfaction from the primary market. Therefore, the Exchange is proposing to amend CHX Article XX, Rules 37(a)(3) and 37(b)(6) to permit, but not require, a CHX specialist to fill limit orders in his book

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

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 46556 (September 26, 2002), 67 FR 61940. The proposed rule change is currently in effect as a pilot. *See* Securities Exchange Act Release Nos. 46577 (September 26, 2002), 67 FR 61941 (October 2, 2002)(notice of immediate effectiveness of pilot for the period September 4, 2002 to October 4, 2002); 46616 (October 8, 2002), 67 FR 63719 (October 15, 2002)(notice of immediate effective of extension of pilot to November 3, 2002.)

[4] *See* Securities Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983). The SROs participating in ITS include the American Stock Exchange LLC (''Amex''), the Boston Stock Exchange, Inc. (''BSE''), the Chicago Board Options Exchange, Inc. (''CBOE''), the Chicago Stock Exchange, Inc. (''CSE''), the Cincinnati Stock Exchange, Inc. (''Cincinnati''), the National Association of Securities Dealers, Inc. (''NASD''), the New York Stock Exchange, Inc. (''NYSE''), the Pacific Stock Exchange, Inc. (''PCX''), and the Phlx (collectively ''Participant Exchanges'').

[5] A trade-through results when a member purchases (or sells) a security at a price that is higher (lower) than the price offered in one or more of the other ITS participant's markets. *See* ITS Plan, Section 8(d)(i).

[6] *See* ITS Plan, Exhibit B.

[7] *See* Phlx Rule 2001A.

[8] *See* Securities Exchange Act Release No. 46428 (August 28, 2002), 67 FR 56607 (September 4, 2002) at 56607 (''ITS Exemption Order'').

[9] *Id.*

[10] *Id.*

[11] *Id.* at 56607–8.

[12] *Id.*

[13] *Id.* at 56608.

when a trade-through that is exempted pursuant to the Commission's ITS Exemption Order occurs in the primary market.

III. Discussion

After careful review, 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.[14] In particular, the Commission finds that the proposed rule is consistent with the requirements of section 6(b)(5) of the Act[15] because it is designed to facilitate transactions in securities; 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; and is not designed to permit unfair discrimination between customers, issuers, brokers or dealers.

By adopting the proposed exemption, the Exchange removes the specialist's obligation to provide trade-through protection in situations where it will not be permitted to seek satisfaction through ITS from the primary market. This obligation was on the CHX assumed voluntarily in order to make its market more attractive to sources of order flow, not an obligation the Act imposes on a market. The Commission believes that the business decision to potentially forego order flow by no longer providing print protection is a judgment the Act allows the CHX to make.[16]

IV. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act,[17] that the proposed rule change (SR–CHX–2002–31) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[18]

Jill M. Peterson,

Assistant Secretary.

[FR Doc. 02–28428 Filed 11–7–02; 8:45 am]

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

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

[16] The Commission notes that the CHX's proposed rule change will remain in effect only until the expiration of the Commission's ITS Exemption Order on June 4, 2003.

[17] 15 U.S.C. 78f(b)(2).

[18] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–46762; File No. SR–CHX–2002–30]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to Eligibility of Limit Orders for Trade Through Protection and Amendment No. 1 Thereto

November 1, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act''),[1] and Rule 19b–4 thereunder,[2] notice hereby is given that on September 13, 2002, the Chicago Stock Exchange, Incorporated (''CHX'' or ''Exchange'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. The Exchange filed the proposal pursuant to section 19(b)(3)(A) of the Act,[3] and Rule 19b–4(f)(6) thereunder,[4] which renders the proposal effective upon filing with the Commission. On October 30, 2002, the Exchange filed Amendment No. 1 to the proposed rule change.[5]

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 CHX Article XX, Rule 37(a)(3) to clarify the rules relating to the execution of limit orders in the specialist's book in the event of a trade through in the primary market. The proposed rule change mirrors a change made to another CHX rule relating to the automated execution of limit orders, which required that a limit order be resident in the specialist's book for a time period of 0–15 seconds (as designated by the specialist) before it would be eligible for limit order protection. The text of the proposed rule change is available from the Office of the Secretary, the Commission, and the CHX.

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

[2] 17 CFR 240.19b–4.

[3] 15 U.S.C. 78s(b)(3)(A).

[4] 17 CFR 240.19b–4(f)(6).

[5] *See* letter from Kathleen M. Boege, Assistant General Counsel, CHX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation, Commission, dated October 29, 2002 (''Amendment No. 1''). In Amendment No. 1, the Exchange corrected typographical errors contained in the proposed rule text.

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

On January 11, 2002, the Commission approved a proposed rule change submitted by the Exchange amending Article XX, Rule 37(b)(6) of the Exchange's rules, which, among other things, governs execution of limit orders in the specialist's book in the event of a trade through in the primary market.[6] That proposal required that a limit order be resident in the specialist's book for a time period of 0–15 seconds (as designated by the specialist) before it would be eligible for limit order protection.

Another provision of the CHX rules, however, also addresses the execution of agency limit orders and should have been amended as part of the Exchange's original proposal.[7] Through this submission, the Exchange modifies CHX Article XX, Rule 37(a)(3) to eliminate any confusion about the impact of the earlier rule change.

2. Statutory Basis

The CHX 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).[8] Specifically, the proposed rule is consistent with section 6(b)(5) of the Act[9] 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

[6] *See* Securities Exchange Act Release No. 45271, 66 FR 2712 (January 18, 2002)(order approving SR–CHX–2001–17).

[7] *See* CHX Article XX, Rule 37(a)(3).

[8] 15 U.S.C. 78f(b).

[9] 15 U.S.C. 78f(b)(5).