

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43600; File No. SR-CHX-00-34]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Chicago Stock Exchange, Incorporated Relating to Its Market Program and Floor Trading Operations

November 21, 2000.

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 October 23, 2000, the Chicago Stock Exchange, Incorporated ("Exchange" or "CHX") 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 CHX. 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 CHX proposes to amend its rules relating to its market maker program and to its floor trading operations. Specifically, the Exchange proposes to amend the following: (i) CHX Rules 8, 9 and 10 under Article XXXIV; (ii) *Interpretations and Policies* of CHX Rule 7 under Article XX; (iii) CHX Rule 10 under Article XX; and (iv) paragraph (b)(12) of CHX Rule 37 under Article XX.

Below is the text of the proposed rule change. Proposed new language is in *italics* and proposed deletions are in brackets.

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ARTICLE XX

Regular Trading Sessions

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Recognized Quotations

RULE 7. No change to text.

Interpretations and Policies:

.01 Specialists shall input their current markets and sizes to the quotation system [through the key terminal or the mark sense terminal] at the post or utilize Exchange systems that provide automated generation of quotations. These quotations shall be firm as to both price and size unless exempted under one of the conditions specified in paragraphs .06-.09 of this Rule.

.02 In respect to Dual Trading System issues specialists utilizing the Auto Quote mode are prohibited from disseminating a bid and/or offer more than \$0.10 (for issues trading in decimals) or 1/8 point (for issues trading in fractions) away from the best ITS market.

.03 Market [M]makers and floor brokers, while at the post, shall provide to the specialist for input to the quotation system their bids and/or offers which better the current Exchange market. *These bids and/or offers, and any modification or withdrawal of these bids and/or offers, must be provided to the specialist through a written quotation ticket or in any other format agreed upon by the specialist and the market maker or floor broker. The specialist must input to the quotation system any bid and/or offer which betters the current Exchange market. For purposes of this rule, a bid or offer will better the current Exchange market if it improves the price of the current bid or offer or if it causes the specialist to change the existing Exchange quotation.* [Such quotations shall remain in force until the market maker leaves the post.]

Market maker and floor broker quotations and accompanying sizes shall be firm unless exempted under one of the conditions specified in paragraphs .06-.09 of this Rule.

Market makers and floor brokers, while at the post, may provide to the specialist their orders to buy or sell securities. The specialist must include these orders in the book to the extent required by Exchange Rules. These orders, and any modification or cancellation of these orders, must be provided to the specialist through a written order ticket or in any other format agreed upon by the specialist and the market maker or floor broker. These orders will remain in effect until cancelled or until they otherwise expire by their terms. If a market or floor broker transfers possession of an order to a specialist, the specialist is responsible for disseminating any required quotations relating to that order.

[.04 Floor Brokers, while at the post, shall input to the quotation system those bids or offers which better the current Exchange market, unless the bid or offer is cancelled or withdrawn if not executed immediately. If a floor broker transfers possession of an order to a specialist, the requirement for input to the quotation system becomes the obligation of the specialist. When a floor broker who retains possession of an order leaves the post he must withdraw his bid or offer from the quotation system. Quotations and accompanying

sizes shall be firm until withdrawn unless exempted under one of the conditions specified in paragraphs .06-.09 of this Rule.]

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Manner of Bidding and Offering

RULE 10. Bids and offers to be effective must be [audibly] made at the post and shall remain in full force until the person making the bid or offer shall [audibly] withdraw the bid or offer [announce that he is out of the market or until he leaves the post].

Interpretations and Policies:

.01 Although there may be a certain amount of negotiation by voice away from the post, every trade must be consummated at the post.

Amended Jan. 15, 1997.

.02 Clearing the Post.

Policy. All orders received by floor brokers or originated by market makers on the floor of the Exchange and Exposable Orders, as that term is defined below, received by specialists on the floor of the Exchange must effectively clear the post before the orders may be routed to another market, either via the ITS System or through the use of alternative means.

Floor brokers who receive an order on the floor have a fiduciary responsibility to seek a best price execution for such order. This responsibility includes clearing of the Exchange's post prior to routing an order to another market so that other buying and selling interest at the post can be checked for a potential execution that may be as good as or better than the execution available in another market.

Market makers, in certain circumstances, are required to provide depth and liquidity to the Exchange market, among other things. Exchange Rules require that all market maker transactions constitute a course of dealings reasonably calculated to contribute to the maintenance of a fair and orderly market. In so doing, market makers must adhere to traditional agency/auction market principles on the floor. Transactions by Exchange market makers on other exchanges or in other markets which fail to clear the Exchange post do not constitute such a course of dealings.

Specialists have an ongoing requirement to provide depth and liquidity to the Exchange market by maintaining liquid continuous two-sided markets on the Exchange floor and insuring that those markets are fair, orderly and efficient in the public interest. To meet those requirements, specialists must adhere to traditional agency/auction market principles on the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

floor. Among other things, these principles require that a specialist not route all or any part of an Exposable Order to another market, either via the ITS System or through the use of alternative means, until the specialist has first exposed the portion of the order that he intends to route elsewhere to any market makers and floor brokers at the post. An Exposable Order is all or any part of an order for more than 100 shares that is either (i) a market order or (ii) a limit order that is at or better than the ITS BBO or NBBO. Transactions by Exchange specialists on other exchanges or in other markets which fail to clear the Exchange post in the manner required by this Interpretation do not constitute a course of dealings that fulfills a specialist's obligation to insure that markets are fair, orderly and efficient in the public interest.

Notwithstanding the above, it is understood that on occasion a customer will insist on special handling for a particular order that would preclude it from clearing the post on the Exchange floor. For example, a customer might request that a specific order be given a primary market execution. These situations must be documented and reported to the Exchange. Customer directives for special handling of all orders in a particular stock or all stocks, however, will not be considered as exceptions to the clearing the post policy.

All executions resulting from bids and offers reflected on Instinet terminals residents on the Exchange floor constitute "orders" which are "communicated" to the Exchange floor. Therefore, all orders resulting from interest reflected on Instinet terminals on the Exchange floor must be handled as any other order communicated to the floor. All such orders must be presented to the post during normal trading hours. All trades between Instinet and Exchange floor members are Exchange trades and must be executed on the Exchange.

Method of Clearing the Post. Subject to Article XX, Rule 11 relating to cabinet securities, the Exchange's clearing the post policy requires the floor broker or market maker to be physically present at the post. A market maker, after requesting the specialist's market quote, must bid or offer the price and size of his intended interest at the post. A floor broker must clear the post by requesting a market quote from the specialist. When required by these rules to clear the post, a specialist must do so by

bidding or offering, at the post, the price and size of his intended interest.

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Guaranteed Execution System and Midwest Automated Execution System

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RULE 37.

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(b)

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(12) Automated Execution of Limit Orders.

A Specialist may voluntarily choose to activate a feature of MAX that automatically executes limit orders on a specialist's book that are at or less than the specialist's auto acceptance level at the limit price after both of the following conditions are met: (1) The issue is trading at the limit price in the primary market, and (2) enough transactions in the issue are executed in the primary market at prices which are equal to the limit price of the order such that the size associated with such transactions are, in aggregate, equal to or greater than the sum of (a) the size displayed at the limit price in the primary market when the limit order was entered on the specialist's book, plus (b) the size of the limit order. This feature can be activated on a stock-by-stock basis only. Once activated, it must remain activated for a minimum of five trading days and can only be deactivated on a certain day (to be determined by the Exchange from time to time) each month.

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ARTICLE XXXIV

Registered Market Makers—Equity Floor

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Joint Participation

RULE 8. (a) Orders Eligible for Joint Participation. Registered market makers are entitled to participate with the specialist in any round lot order in the specialist's book that is greater in size than a specialist's auto-acceptance threshold for that security. When requested by a specialist or floor broker to make a market with respect to any other order, a registered market maker is also entitled to participate in that order with the specialist or floor broker.

(b) Extent of Joint Participation. When the bids or offers of one or more registered market makers are equal in price to those of the specialist with respect to the orders described above, the registered market maker or market makers as a group are entitled to participate in the transactions effected

on those orders [thereon] to the extent of [one-third] 40% of the total shares involved (excluding those needed to satisfy public orders).

When the bids or offers of one or more registered market makers are better in price than those of the specialist, the registered market maker or market makers as a group are entitled to the entire transaction.

Interpretations and Policies:

.01 No change to text.

Openings

RULE 9. Registered market makers as a group are entitled to participate in opening a security on the Exchange to the extent of [one-third] 40% of the net imbalance (excluding specialist participation) of purchase and sale orders on the Exchange.

Public Outcry

RULE 10. No specialist [or market maker] shall effect a transaction for his own account with respect to any order greater in size than his auto-acceptance threshold for that security until the specialist has first exposed that order to any market makers and floor brokers at the post. Nothing in this Rule prevents specialists from exposing, to any market makers and floor brokers at the post, any order that is equal or smaller in size than his auto-acceptance threshold. [unless the presence of the other side of that transaction had been audibly announced at the post.]

No market maker shall effect a transaction for his own account with respect to any order until the market maker has first exposed that order to the specialist and any market makers or floor brokers at the post.

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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 CHX included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. 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 Statements of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to modify the CHX's market maker program ("Program") and to make certain changes to reflect technical enhancements to the CHX's trading operations.

Changes to the Market Maker Program. The Program was originally designed to provide supplemental liquidity to specialists on the CHX by permitting auxiliary market makers to trade for their own accounts on the floor of the CHX. Currently, the CHX market makers are required to fulfill certain market-making obligations, and in return are granted a one-third participation right in shares presented to the specialist for purchase or sale.

The CHX is engaged in an examination of how to reconfigure its operations in order to compete in a technologically driven marketplace that has begun to face competition from electronic communication networks ("ECNs") and the NASDAQ Stock Market, Inc. ("NASDAQ") in listed stocks. As part of this evaluation, the CHX recognized that it needs to continue to increase the automation of its trading operations and address the role of floor traders on the CHX, especially market makers that do not contribute substantially to the liquidity of the Exchange.

The CHX's evaluation included an analysis of trading by market makers. This analysis found that market makers rarely supply liquidity outside of several exchange-traded funds ("ETFs"). Specifically, market makers participate in less than 0.83% of trade volume outside of ETFs. For ETFs, especially the NASDAQ 100 Depository Receipts, market makers often participate in trades of 5,000 shares or greater. They accounted for 17% of the share volume of four ETFs during a sample period examined by the CHX (but only 2.4% of the trade volume in these issues), and a significant portion of the 17% of share volume involved market makers trading with brokers who were filling customer orders for large transactions.

In light of the data, the CHX explored several approaches to address market maker activity. One approach would have eliminated market makers because their activity is limited almost entirely to participating in large ETF transactions. In response to concerns by some members about eliminating market makers and the liquidity they provide to large, brokered orders, the CHX decided

to focus on encouraging market maker participation in large orders and stimulating increased quote competition for small orders.

This proposed rule change would implement the CHX's modification of market maker obligations. Under the proposed rule change, registered market makers would be entitled to participate with the specialist in any round lot order in the specialist's book that is greater in size than the specialist's auto-acceptance threshold for a given security. For these orders, if the bids or offers of one or more registered market makers are equal to those of the specialist, the registered market maker or market makers as a group would be entitled to participate in forty percent of the total shares involved (excluding the shares needed to satisfy public orders).³ Prior to effecting a transaction for its own account, a specialist must expose any order greater than its auto-acceptance size to market makers and floor brokers at the post. Furthermore, when the bids or offers of one or more market makers are better than those of the specialist, the market maker or market makers as a group would be entitled to participate fully in the transaction without the specialist.

With respect to orders at or less than the specialist's auto-acceptance threshold, the specialist could still request market maker interaction, in which event the market maker would be entitled to participate in that order. In addition, a specialist must request such interaction if the specialist chooses not to fill an order within the auto-acceptance parameters. A floor broker or specialist can also request market maker participation in a floor broker order. Market makers in these situations would also be entitled to participate in forty percent of the trade.

Under the proposed rules, market makers and floor brokers must continue to provide the specialist with their bids and/or offers that better the current CHX market. The specialist must input these bids and offers to the quotation system. Market makers and floor brokers may also provide their orders to buy or sell securities to the specialist, in which event the specialist must include these orders in the book as required by the CHX rules.

The proposed rule change limits market makers' ability to participate in small sized orders unless they improve the CHX quote, but offers them increased participation rights for larger

sized orders and for those orders for which their participation is requested by a specialist. As a whole, the CHX believes that the proposed rule change does not alter the Program significantly, other than for small sized orders, which have not been subject to much market maker participation in the past.

The intent of the proposed rule change is to stimulate market makers to continue to provide liquidity for larger orders by increasing their participation rights for those orders. Similarly, the proposed rule change could increase quote competition on the CHX in smaller size orders by creating incentives for market makers to improve the specialist's quote. As discussed above, a market maker who improves the specialist's quote would be entitled to participate in the entire transaction. This is a change from the current rules which allows market makers to receive one-third participation for merely matching a specialist's quote. The new rule would force market makers to improve the quote to participate in a trade, but reward such improvement by providing a greater participation right to the market maker. CHX believes that this proposed rule change is consistent with the recent SEC proposals to strengthen quote competition.⁴ The proposed rule change thus has the potential to benefit retail investors whose orders are usually executed automatically based on the national best bid or offer ("NBBO") because market makers would have an incentive to narrow spreads in order to participate in the entire order.

Modifications to Trading Floor Operations Rules. The proposed rule change also makes several changes to floor procedure to incorporate the use of existing technology on the Exchange floor. The change to Interpretation .01 to CHX Rule 7 of Article XX reflects the replacement of key terminals and mark sense terminals with other Exchange systems and the use of Exchange auto-quote systems.⁵ The change to Interpretation .03 to CHX Rule 7 of Article XX is intended to reduce disputes as to whether market makers and floor brokers properly vocalized their bids and offers for input into the

⁴ See Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406 (August 8, 2000) (Proposing Release on Disclosure of Order Routing and Execution Practices discussing the need to strengthen quote competition). See also Securities Exchange Act Release No. 43590 (November 17, 2000).

⁵ A similar change to this Interpretation has also been proposed in SR-CHX-99-18 (filed September 24, 1999), a filing which was primarily designed to modify the CHX's description of its limit order display rule (Article XX, Rule 7, Interpretation and Policy .05).

³ This participation right is an increase from the current one-third participation right. The new participation level would also apply to openings as provided by Rule 9, Article.

Exchange's quotation system. The proposal would require bids or offers that better the Exchange market⁶ to be provided to the specialist via written ticket, or by any other form agreed upon by the specialist and market maker or floor broker. The proposed rule change also contains a similar requirement for limit orders left with the specialist by market makers or floor brokers.

The CHX is making a few changes to its CHX Rule 10 of Article XX. The first change would reflect the changes made to CHX Rule 7 of Article XX by removing the audibalization requirement. Because bids and offers will have to be provided to the specialist for input into the Exchange's quotation system, the audibalization requirement is no longer necessary. The proposed rule change also adds language to require specialists to adhere to agency/auction market principles. Among other things, specialists are required to clear the post of exposable orders they received on the floor.⁷ Thus, a specialist would not be permitted to route exposable orders to another market until the specialist has first exposed the portion of the order that he intends to route to another market to market makers and floor brokers at the post. The intent of the proposed rule change is to extend to specialists the requirement of clearing the post that now applies to orders received by floor brokers and market makers on the floor of the Exchange. The CHX believes it is consistent with exchange auction market principles to require all market orders and marketable or displayable limit orders received by the specialist to have the opportunity to interact with other interest on the Exchange floor before being routed to another market.

Finally, the CHX is proposing to amend CHX Rule 37 of Article XX to limit the automatic execution feature of MAX, the Exchange's automatic execution system, for limit orders at or less than the specialist's auto acceptance level. Currently, if a specialist chooses to activate the limit order auto-ex feature, he must do so for all limit orders on the book regardless

⁶ To better the market, the quote would have to improve the CHX quote by one quoting increment, or otherwise cause the specialist to change the existing CHX quotation. Currently, Article XX, Rule 7, Interpretation .05 requires a specialist to input any bids or offers that increase the size that has been bid or offered at the current price. The CHX has proposed an amendment to this provision in SR-CHX-99-18, which is pending with the Commission.

⁷ An exposable order will be defined in the proposed rule change as "all or any part of an order for more than 100 shares that is either (i) a market order or (ii) a limit order that is at or better than the ITS best bid or offer or the national best bid or offer."

of size. By allowing the specialist to automatically execute these limit orders only when the orders are of a size at or less than his auto acceptance level, the specialist will be required to present larger orders to the crowd as required by the new market maker participation rules. Of course, specialists will still be obligated to exercise care and diligence to provide quality executions to manually handled limit orders if the two conditions of paragraph (b)(12) of CHX Rule 37 of Article XX are triggered by executions in the primary market.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6⁸ and Section 11⁹ of the Act. The proposal furthers the objectives of Section 6(b)(5)¹⁰ of the Act in particular in that it should promote just and equitable principles of trade, serve to remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest. The proposal is also consistent with Rule 11b-1¹¹ of the Act because it is designed to require specialists and market makers to assist in the maintenance of a fair and orderly market.

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

The Exchange believes that the proposed rule change does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The CHX believes that the proposed rule change will enhance competition on the Exchange by providing an incentive for the CHX market makers to aggressively compete on quotes.

C. Self-Regulatory Organization's Statement on Comments on 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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer 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

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78k.

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ 17 CFR 240.11b-1.

(ii) as to which the Exchange consents, the Commission will:

(A) by order approve such 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 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549-0609. 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 submissions should refer to File No. SR-CHX-00-34 and should be submitted by December 20, 2000.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-43577; File No. SR-CHX-00-37]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the Chicago Stock Exchange, Incorporated, Relating to the Exchange's SuperMAX 2000 Price Improvement Program

November 16, 2000.

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 November

¹² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.