

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-64418; File No. SR-CHX-2011-08]

### Self-Regulatory Organizations; Chicago Stock Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Related to the Treatment of Customer Orders and the Prohibition Against Trading Ahead of Customer Orders

May 6, 2011.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on April 26, 2011, the Chicago Stock Exchange, Incorporated ("Exchange" or "CHX") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange filed the proposal as a "non-controversial" proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>3</sup> and Rule 19b-4(f)(6) thereunder.<sup>4</sup> 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 9, Rule 17 which rule governs the treatment of customer orders and the prohibition against trading ahead of customer orders. The text of this proposed rule change is available on the Exchange's Web site at (<http://www.chx.com>), at the Exchange's Office of the Secretary, on the Commission's Web site at <http://www.sec.gov>, and in the Commission's Public Reference Room.

#### 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 Change

##### 1. Purpose

The Exchange is proposing to amend Article 9, Rule 17 of its rules which governs the treatment of customer orders and prohibits a CHX Participant<sup>5</sup> from proprietary trading ahead of a customer order. Specifically, this proposal includes redrafting of the customer order protection rule language and adds a number of exceptions to the rule in order to make the rule more consistent with the Financial Industry Regulatory Authority's ("FINRA") Rule 5320.

##### Customer Order Protection

Currently, CHX Article 9, Rule 17 states, in part, that a Participant is prohibited from trading proprietary while the Participant personally holds or has knowledge that the Participant (or any partner, officer or director thereof) holds an unexecuted market or limit order to buy (sell) such security in the unit of trading for a customer. The proposed rule change still includes customer order protection language as it applies to unexecuted market and limit orders with the clarification of allowing a Participant, who has traded proprietary ahead of a customer order, to immediately thereafter execute the customer order up to the size and at the same or better price at which it traded for its own account. In other words, in the event that a Participant trades ahead of an unexecuted customer order at a price that is equal to or better than the unexecuted customer order, such Participant is required to execute the customer order at the price received by the Participant or better; otherwise the Participant shall be in violation of improperly trading ahead of such customer order. The proposal also prescribes the minimum "level" of price improvement necessary for a Participant to execute an order on a proprietary basis when holding an unexecuted

customer limit order. For example, for customer limit orders priced greater than or equal to \$1.00, the minimum amount of price improvement required is \$0.01.

The Exchange also proposes to establish that a Participant must have written procedures in place governing the execution and priority of all pending orders that is consistent with the best execution requirements of CHX Article 17, Rule 3(d) and ensure that these procedures are consistently applied.

In furtherance of ensuring customer order protection, the proposed rule change clarifies Participant obligations in handling marketable customer orders. In meeting these obligations, a Participant must make every effort to execute a marketable customer order that it receives fully and promptly. A Participant that is holding a customer order that is marketable and has not been immediately executed must make every effort to cross such order with any other order received by the Participant on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent order is received by the Participant and that is consistent with the terms of the orders. In the event that a Participant is holding multiple orders on both sides of the market that have not been executed, the Participant must make every effort to cross or otherwise execute such orders in a manner that is reasonable and consistent with the objectives of the proposed rule and with the terms of the orders.

##### Large Orders and Institutional Accounts

In addition, the Exchange is proposing to add several exceptions to the customer order protection rule. The most notable exception is to allow Participants to negotiate terms and conditions on the acceptance of certain large-sized orders (orders of 10,000 shares or more and greater than \$100,000 in value) or orders from institutional accounts as defined in this proposal as Interpretation and Policy .09 of CHX Article 9, Rule 17 (collectively referred to as "Institutional/Large-Sized Orders"). Such terms and conditions would permit the Participant to continue to trade along side or ahead of such customer orders if the customer agrees.

Specifically, under the proposed rule, a Participant would be permitted to trade a security on the same side of the market for its own account at a price that would satisfy a customer order provided that the Participant provides clear and comprehensive written disclosure to each customer at account

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>4</sup> 17 CFR 240.19b-4(f)(6).

<sup>5</sup> Pursuant to CHX Article 1, Rule 1(s), a "Participant" means any Participant Firm that holds a valid Trading Permit and any person associated with a Participant Firm who is registered with the Exchange under CHX Articles 16 and 17 as a Market Maker Trader or Institutional Broker Representative, respectively. A Participant shall be considered a "member" of the Exchange for purposes of the Exchange Act. If a Participant is not a natural person, the Participant may also be referred to as a "Participant Firm," but unless the context requires otherwise, the term Participant shall refer to an individual Participant and/or a Participant Firm.

opening and annually thereafter that: (a) Discloses that the Participant may trade proprietarily at prices that would satisfy the customer order, and (b) provides the customer with a meaningful opportunity to opt in to the CHX Article 9, Rule 17 protections with respect to all or any portion of its order(s).

If a customer does not opt in to the protections with respect to all or any portion of its order(s), the Participant may reasonably conclude that such customer has consented to the Participant trading a security on the same side of the market for its own account at a price that would satisfy the customer's order.<sup>6</sup>

In lieu of providing written disclosure to customers at account opening and annually thereafter, the proposed rule would permit Participants to provide clear and comprehensive oral disclosure to, and obtain consent from, a customer on an order-by-order basis, provided that the Participant documents who provided such consent and that such consent evidences the customer's understanding of the terms and conditions of the order. In addition, where a customer has opted in to the CHX Article 9, Rule 17 protections, a Participant may still obtain consent on an order-by-order basis to trade ahead of or along with an order from that customer, provided that the Participant documents who provided such consent and that such consent evidences the customer's understanding of the terms and conditions of the order.<sup>7</sup>

#### No-Knowledge Exception

The Exchange is also proposing to add a "no-knowledge" exception to its customer order protection rule. The proposed exception would allow a proprietary trading unit of a CHX Participant firm to continue trading in a proprietary capacity and at prices that

<sup>6</sup> As is always the case, customers retain the right to withdraw consent at any time. Therefore, a Participant's reasonable conclusion that a customer has consented to the Participant trading along with such customer's order is subject to further instruction and modification from the customer.

<sup>7</sup> While a firm relying on this or any exception must be able to proffer evidence of its eligibility for and compliance with the exception, CHX believes that when obtaining consent on an order-by-order basis, Participants must, at a minimum, document not only the terms and conditions of the order (*e.g.*, the relative price and size of the allocated order/percentage split with the customer), but also the identity of the person at the customer who approved the trade-along request. For example, the identity of the person must be noted in a manner that will enable subsequent contact with that person if a question as to the consent arises (*i.e.*, first names only, initials, and nicknames will not suffice). A trade along request would be when a CHX Participant asks to trade for his/her proprietary account while simultaneously holding and working a customer order in that same stock.

would satisfy customer orders that were being held by another, separate trading unit at the Participant firm. The "no-knowledge" exception would be applicable with respect to NMS stocks, as defined in Rule 600 of SEC Regulation NMS. In order to avail itself of the "no-knowledge" exception, a Participant firm must first implement and utilize an effective system of internal controls (such as appropriate information barriers) that operate to prevent the proprietary trading unit from obtaining knowledge of the customer orders that are held at a separate trading unit. For example, a CHX Institutional Broker<sup>8</sup> that conducts both a proprietary and agency brokerage business and has implemented and utilized an effective system of internal controls, the "walled off" proprietary desk(s) of such Institutional Broker would be permitted to trade at prices that would satisfy the customer orders held by the agency brokerage desk without any requirement that such proprietary executions trigger an obligation to fill pending customer orders at the same price. The "no-knowledge" exception would also apply to a Participant firm's market-making unit.

A Participant that structures its order handling practices in NMS stocks to permit its proprietary and/or market-making desk to trade at prices that would satisfy customer orders held as [sic] a separate trading unit must disclose in writing to its customers, at account opening and annually thereafter, a description of the manner in which customer orders are handled by the Participant and the circumstances under which the Participant may trade proprietarily at its market-making desk at prices that would satisfy the customer order.

To the extent a Participant firm structures its order handling practices in NMS stocks to "wall off" customer order flow from its proprietary/market-making desks, CHX is proposing to require the firm to disclose that fact in writing to its customers. This disclosure would include a description of the manner in which customer orders are handled and the circumstances under which the firm may trade proprietarily at prices that would satisfy a customer order. The proposed disclosure would be required at account opening and on an annual basis thereafter and may be combined with the disclosure and negative

<sup>8</sup> Pursuant to CHX Article 1, Rule 1(n), an Institutional Broker means a member of the Exchange who is registered as an institutional broker and has satisfied all Exchange requirements to operate as an institutional broker on the Exchange.

consent statement permitted in connection with the proposed Institutional/Large-Sized Order exception.

#### Riskless Principal Exception

The Exchange's proposal also clarifies that the obligations under this rule shall not apply to a Participant's proprietary trade if such proprietary trade is for the purposes of facilitating the execution, on a riskless principal basis, of another order from a customer (whether its own customer or the customer of another broker-dealer), provided that the Participant: (a) Submits a report, contemporaneously with the execution of the facilitated order, identifying the trade as riskless principal to CHX and (b) has written policies and procedures to ensure that riskless principal transactions relied upon for this exception comply with applicable CHX rules. At a minimum these policies and procedures must require that the customer order was received prior to the offsetting principal transaction, and that the offsetting principal transaction is at the same price as the customer order exclusive of any markup or markdown, commission equivalent or other fee and is allocated to a riskless principal or customer account in a consistent manner and within 60 seconds of execution.

Participants must have supervisory systems in place that produce records that enable the Participant and CHX to reconstruct accurately, readily, and in a time-sequenced manner all orders on which a Participant relies in claiming this exception.

#### ISO Exception

The filing also clarifies that a Participant shall be exempt from the obligation to execute a customer order in a manner consistent with the customer order protection rule with regard to trading for its own account that is the result of an intermarket sweep order routed in compliance with Rule 600(b)(30)(ii) of SEC Regulation NMS ("ISO") where the customer order is received after the Participant routed the ISO. Where a Participant routes an ISO to facilitate a customer order and that customer has consented to not receiving the better prices obtained by the ISO, the Participant also shall be exempt with respect to any trading for its own account that is the result of the ISO with respect to the consenting customer's order.

#### Odd Lot and Bona Fide Error Exception

In addition, the Exchange proposes applying an exception for a firm's proprietary trade that (1) Offsets a

customer odd lot order (*i.e.*, an order less than one round lot, which is typically 100 shares); or (2) corrects a bona fide error. With respect to bona fide errors, Participant firms would be required to demonstrate and document the basis upon which a transaction meets the bona fide error exception. For purposes of this rule, the definition of a "bona fide error" is as defined in SEC Regulation NMS's exemption for error correction transactions.<sup>9</sup>

#### Trading Outside Normal Market Hours

This proposal also expands the customer order protection requirements to apply at all times that a customer order is executable by the Participant, even outside the period of normal market hours. Thus, customers would have the benefit of the customer order protection rules at all times where such order is executable by the Participant firm, subject to any applicable exceptions. This exception shall apply to those Participants that accept customer orders after normal market hours.

#### 2. Statutory Basis

CHX believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that CHX rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade and, in general, to protect investors and the public interest. CHX believes that amending its customer order protection rule as proposed, will bring it more in line with industry standards, most notably FINRA's Rule 5320, which we believe will in turn reduce the complexity of customer order protection for those firms subject to the rules of multiple trading venues. CHX also believes that changing its rule as proposed will maintain the necessary protection of customer orders without imposing any undue regulatory costs on industry participants.

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

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

#### *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

The Exchange has filed the proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act<sup>10</sup> and Rule 19b-4(f)(6) thereunder.<sup>11</sup> Because the foregoing proposed rule change does not: (i) Significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative prior to 30 days from the date on which it was filed, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(6) thereunder.<sup>12</sup>

CHX will announce the implementation date of the proposed rule change in a Regulatory Notice to be issued no later than 90 days from the date of publication of notice in the **Federal Register**. Implementation of the rule will take effect no later than 90 days from the date when the Exchange issues the Regulatory Notice.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### 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. 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

<sup>10</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>11</sup> 17 CFR 240.19b-4(f)(6).

<sup>12</sup> In addition, Rule 19b-4(f)(6)(iii) requires the self-regulatory organization to submit to the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CHX-2011-08 on the subject line.

##### *Paper Comments*

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-CHX-2011-08. 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 Web site viewing and printing in the Commission's Public Reference Room on official business days between the hours of 10 a.m. and 3 p.m. 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-2011-08 and should be submitted on or before June 2, 2011.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>13</sup>

**Elizabeth M. Murphy.**

*Secretary.*

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**BILLING CODE 8011-01-P**

<sup>9</sup> Securities Exchange Act Release No. 55884 (June 8, 2007), 72 FR 32926 (June 14, 2007) (Order Exempting Certain Error Correction Transactions from Rule 611 of Regulation NMS under the Securities Exchange Act of 1934).

<sup>13</sup> 17 CFR 200.30-3(a)(12).