SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51303; File No. SR-CHX-2005-05)

March 2, 2005

Self-Regulatory Organizations; Chicago Stock Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to the Extension of a Pilot Relating to Transactions in Certain Exchange-Traded Funds

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Act"),[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on March 2, 2005, the Chicago Stock Exchange, Incorporated ("CHX" or "Exchange") filed with the Securities and Exchange Commission (the "Commission") a request for reinstatement and extension of a pilot rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange filed the proposed rule change pursuant to Section 19(b)(3)(A) of the Act,[3] and Rule 19b-4(f)(6)[4] thereunder, which renders the rule change effective upon filing with the Commission.[5] The Commission is publishing this notice to solicit comments on the proposal from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

In its submission, the Exchange requested extension of a pilot rule change to CHX Article XX, Rule 37(a), which governs manual execution of eligible market and marketable limit orders. The pilot rule change, which will remain in effect for an

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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 The Commission waived the 5-day prefiling notice requirement.

additional 60-day pilot period, permits a CHX specialist, acting in its principal capacity, to manually execute an incoming market or marketable limit order in one of three exchange-traded funds at a price other than the national best bid or offer.

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

On August 28, 2002, the Commission issued an order granting a de minimis exemption ("Exemption") for transactions in certain exchange-traded funds ("Exempt ETFs")[6] from the trade-through provisions of the Intermarket Trading System ("ITS") Plan.[7]

As stated by both Commission staff and Commissioners at an open meeting on August 27, 2002, rapid-fire quotations and executions in Exempt ETFs occur consistently throughout the trading day within a range around the NBBO, rendering it extremely

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6 The three affected Exempt ETFs are the exchange-traded funds tracking the Nasdaq-100 Index ("QQQ"), the Dow Jones Industrial Average ("DIAMONDs") and the Standard & Poor's 500 Index ("SPDRs").

7 See Securities Exchange Act Release No. 46428 (August 28, 2002). At present, the Exemption extends to transactions that are "executed at a price that is no more than three cents lower than the highest bid displayed in CQS and no more than three cents higher than the lowest offer displayed in CQS."

difficult, if not impossible, to access liquidity at an exact NBBO price point. Compounding the "flickering" noted by the Commission, the Exchange has noted a marked increased in the incidence of locked and crossed markets in Exempt ETFs.

CHX Article XX, Rule 37(a), commonly referred to as the Exchange's "Best Rule," requires that with respect to any market or marketable limit order not executed automatically, a CHX specialist must ". . . either (a) manually execute such order at a price and size equal to the NBBO price and size the time the order was received; or (b) act as agent for such order in seeking to obtain the best available price for such order on a marketplace other than the Exchange, using order routing systems where appropriate."

Given the unique environment in which the ETFs are traded, and the difficulty that CHX specialists often encounter in accessing NBBO price points, the Exchange's Department of Market Regulation ("Department") believes that its enforcement of the Best Rule must take the ETF trading environment into account when the Department evaluates the execution prices of eligible market and marketable limit orders for Exempt ETFs. The Department believes that in certain instances, execution of an order in an Exempt ETF at a price other than the NBBO may nonetheless be consistent with the specialist's best execution obligation, in light of the unique environment that characterizes trading in Exempt ETFs. The Exchange believes that the current version of the BEST Rule contains sufficient latitude with respect to an order executed by a CHX specialist acting as agent for the order,[8] but does not contemplate any flexibility for

[8] The Best Rule provision governing manual agency executions obligates the CHX specialist to seek "… the best **available** price." CHX Article XX, Rule 37(a)(2).

specialists acting in their principal capacity.[9] Accordingly, the Exchange obtained pilot approval of the attached rule change, which permits a CHX specialist, acting in its principal capacity, to manually execute an incoming market or marketable limit order in an Exempt ETF at a price other than the NBBO.[10] The pilot expired on February 24, 2005.[11] Accordingly, the Exchange requests reinstatement and a sixty-day extension of the pilot rule change; the pilot rule text incorporated into this submission as Exhibit 5 does not differ in any respect from the existing pilot rule provisions.

Significantly, the pilot rule change does not excuse a CHX specialist from their best execution obligations with respect to manually-executed orders. Moreover, the pilot rule change only relates to orders that are executed manually, when a CHX specialist's ability to obtain liquidity at an exact NBBO price point is extremely limited. Orders that are executed automatically will continue to be executed by the Exchange's MAX® automated execution system at the NBBO in effect at the time the order is received.

2. Statutory Basis

The CHX believes the proposal is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities exchange,

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9 The Best Rule provision governing manual principal executions obligates the CHX specialist to execute the order at the "… **NBBO price and size** at the time the order was received." CHX Article XX, Rule 37(a)(2).

10 This rule change is closely analogous to the Exchange's previously submitted interpretation regarding execution of resting limit orders in Exempt ETFs. Under the limit order interpretation, CHX specialists need not provide execution guarantees for Exempt ETFs, based on trade-throughs by other markets, that CHX specialists typically provide to all other listed issues. See Securities Exchange Act Release No. 46557 (September 26, 2002), 67 FR 61941 (October 2, 2002).

11 See Securities Exchange Act Release No. 50935 (December 27, 2004), 70 FR 414 (January 4, 2005).

and, in particular, with the requirements of Section 6(b).[12] The CHX believes the proposal is consistent with Section 6(b)(5) of the Act[13] 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 general, to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

Because the foregoing proposed pilot 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 for 30 days from the date on which it was filed, or such shorter time as the Commission may designate,

it has become effective pursuant to Section 19(b)(3)(A) of the Act [14]and Rule 19b-4(f)(6) thereunder.[15] At any time during the 60-day pilot period, the Commission may

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12 15 U.S.C. 78(f)(b).

13 15 U.S.C. 78f(b)(5).

14 15 U.S.C. 78s(b)(3)(A).

15 17 CFR 240.19b-4(f)(6).

summarily abrogate 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.

The Exchange has requested that the Commission waive the 30-day operative delay in Rule 19b-4(f)(6)(iii). The Commission believes such waiver is consistent with the protection of investors and the public interest because it will allow the pilot to operate without delay. For this reason, the Commission designates the proposal to be effective and operative upon filing with the Commission.[16]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposal 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
- Send an e-mail to rule-comments@sec.gov. Please include File No. SR-CHX-2005-05 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.

16 For purposes only of waiving the 30-day operative delay, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

All submissions should refer to File No. SR-CHX-2005-05. 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 changes 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 the filing will also 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 No. SR-CHX-2005-05 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

Margaret H. McFarland
Deputy Secretary

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