

## 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. 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 has requested a one-year extension of the pilot relating to the trading of Nasdaq/NM securities on the Exchange. Specifically, the pilot amends CHX Article XX, Rule 37 and CHX Article XX, Rule 43. The pilot currently is due to expire on November 1, 2003; the Exchange proposes that the amendments remain in effect on a pilot basis through November 1, 2004.

On May 4, 1987, the Commission approved certain Exchange rules and procedures relating to the trading of Nasdaq/NM securities on the Exchange.<sup>3</sup> Among other things, these rules rendered the Exchange's BEST Rule guarantee (CHX Article XX, Rule 37(a)) applicable to Nasdaq/NM securities and made Nasdaq/NM securities eligible for the automatic execution feature of the Exchange's Midwest Automated Execution System (the "MAX" system).<sup>4</sup>

On January 3, 1997, the Commission approved, on a one year pilot basis, a program that eliminated the requirement that CHX specialists automatically execute orders for Nasdaq/NM securities when the

specialist is not quoting at the national best bid or best offer disseminated pursuant to SEC Rule 11Ac1-1 (the "NBBO").<sup>5</sup> When the Commission approved the program on a pilot basis, it requested that the Exchange submit a report to the Commission describing the Exchange's experience with the pilot program. The Commission stated that the report should include at least six months of trading data. Due to programming issues, the pilot program was not implemented until April 1997. Six months of trading data did not become available until November 1997. As a result, the Exchange requested an additional three-month extension to collect the data and prepare the report for the Commission.

On December 31, 1997, the Commission extended the pilot program for an additional three months, until March 31, 1998, to give the Exchange additional time to prepare and submit the report and to give the Commission adequate time to review the report prior to approving the pilot on a permanent basis.<sup>6</sup> The Exchange submitted the report to the Commission on January 30, 1998. Subsequently, the Exchange requested another three-month extension, in order to give the Commission adequate time to approve the pilot program on a permanent basis. On March 31, 1998, the Commission approved the pilot for an additional three-month period, until June 30, 1998.<sup>7</sup> On July 1, 1998, the Commission approved the pilot for an additional six-month period, until December 31, 1998.<sup>8</sup> On December 31, 1998, the Commission approved the pilot for an additional six-month period, until June 30, 1999.<sup>9</sup> On June 30, 1999, the Commission approved the pilot for an additional seven-month period, until January 31, 2000.<sup>10</sup> On January 31, 2000, the Commission approved the pilot for an additional three-month period, until May 1, 2000.<sup>11</sup> On May 1, 2000, the Commission approved the pilot for an additional six-month period, until November 1, 2000.<sup>12</sup> On November 15, 2000, the Commission approved the

pilot for an additional one-year period, until November 1, 2001.<sup>13</sup> On November 1, 2001, the pilot was extended for an additional one-year period, until November 1, 2002.<sup>14</sup> On November 1, 2002, the pilot was extended for an additional one-year period, until November 1, 2003.<sup>15</sup> In light of the evolving nature of the Nasdaq market and unlisted trading of Nasdaq/NM securities, the Exchange now requests another extension of the current pilot program, through November 1, 2004. The Exchange is not requesting approval of any changes to the pilot in this submission.

Under the pilot program, specialists must continue to accept agency market orders<sup>16</sup> or marketable limit orders, but only for orders of 100 to 5099 shares in Nasdaq/NM securities. This threshold order acceptance requirement is referred to as the "auto acceptance threshold." Specialists, however, must accept all agency limit orders in Nasdaq/NM securities from 100 up to and including 10,000 shares for placement in the limit order book. Specialists are required to automatically execute Nasdaq/NM orders in accordance with certain amendments to the pilot program that were approved by the Commission.<sup>17</sup>

The pilot program requires the specialist to set the MAX auto-execution threshold at 100 shares or greater for Nasdaq/NM securities. When a CHX specialist is quoting at the NBBO, orders for a number of shares less than or equal to the size of the specialist's quote are executed automatically (in an amount up to the size of the specialist's quote). Orders of a size greater than the specialist's quote are automatically executed up to the size of the specialist's quote, with the balance of the order designated as an open order in the specialist's book, to be filled in accordance with the Exchange's rules for manual execution of orders for Nasdaq/NM securities. Such rules

<sup>3</sup> See Securities Exchange Act Release No. 24424 (May 4, 1987), 52 FR 17868 (May 12, 1987) (order approving File No. SR-MSER-87-2); see also Securities Exchange Act Release Nos. 28146 (June 26, 1990), 55 FR 27917 (July 6, 1990) (order expanding the number of eligible securities to 100); 36102 (August 14, 1995), 60 FR 43626 (August 22, 1995) (order expanding the number of eligible securities to 500); 41392 (May 12, 1999), 64 FR 27839 (May 21, 1999) (order expanding the number of eligible securities to 1000).

<sup>4</sup> The MAX system may be used to provide an automated delivery and execution facility for orders that are eligible for execution under the Exchange's BEST Rule and certain other orders. See CHX Rules, Art. XX, Rule 37(b). A MAX order that fits within the BEST parameters is executed pursuant to the BEST Rule via the MAX system. If an order is outside the BEST parameters, the BEST rule does not apply, but MAX system handling rules remain applicable.

<sup>5</sup> See Securities Exchange Act Release No. 38119 (January 3, 1997), 62 FR 1788 (January 13, 1997).

<sup>6</sup> See Securities Exchange Act Release No. 39512 (December 31, 1997), 63 FR 1517 (January 9, 1998).

<sup>7</sup> See Securities Exchange Act Release No. 39823 (March 31, 1998), 63 FR 17246 (April 8, 1998).

<sup>8</sup> See Securities Exchange Act Release No. 40150 (July 1, 1998), 63 FR 36983 (July 8, 1998).

<sup>9</sup> See Securities Exchange Act Release No. 40868 (December 31, 1998), 64 FR 1845 (January 12, 1999).

<sup>10</sup> See Securities Exchange Act Release No. 41586 (June 30, 1999), 64 FR 36938 (July 8, 1999).

<sup>11</sup> See Securities Exchange Act Release No. 42372 (January 31, 2000), 65 FR 6425 (February 9, 2000).

<sup>12</sup> See Securities Exchange Act Release No. 42740 (May 1, 2000) 65 FR 26649 (May 8, 2000).

<sup>13</sup> See Securities Exchange Act Release No. 43565 (November 15, 2000), 65 FR 71166 (November 29, 2000).

<sup>14</sup> See Securities Exchange Act Release No. 45010 (November 1, 2001), 66 FR 56585 (November 8, 2001).

<sup>15</sup> See Securities Exchange Act Release No. 46932 (November 29, 2002), 67 FR 72990 (December 9, 2002).

<sup>16</sup> The term "agency order" means an order for the account of a customer, but does not include professional orders, as defined in CHX Rules, Art. XXX, Rule 2, Interpretation and Policy .04. The rule defines a "professional order" as any order for the account of a broker-dealer, the account of an associated person of a broker-dealer, or any account in which a broker-dealer or an associated person of a broker-dealer has any direct or indirect interest.

<sup>17</sup> See Securities Exchange Act Release No. 44778 (September 7, 2001), 66 FR 48075 (September 17, 2001).