

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50054; File No. SR-PCX-2004-49)

July 21, 2004

Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing of a Proposed Rule Change to Amend its Rules Governing the Archipelago Exchange by Adding a New Order Modifier Entitled “Don’t Arb Me”

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 June 3, 2004, the Pacific Exchange, Inc. (“PCX” or “Exchange”), through its wholly owned subsidiary PCX Equities, Inc. (“PCXE”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. 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 is proposing to amend its rules governing the Archipelago Exchange (“ArcaEx”), the equities trading facility of PCXE, to add a new order type entitled the “Don’t Arb Me” modifier. The “Don’t Arb Me” modifier will increase processing capability for orders in exchange-listed securities that are traded-through by an away market block trade. The text of the proposed rule change appears below. New text is in italics.

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Rule 7

Equities Trading

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Orders and Modifiers

Rule 7.31 Orders and Modifiers

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(dd) Don't Arb Me Modifier. A limit order in which the Corporation will re-price the order at the block price subsequent to the limit order being traded-through by another market center's block trade. The order shall be ranked in the Arca Book pursuant to Rule 7.36 and assigned a new time price priority as of the time of each reposting. This modifier will apply only to exchange-listed securities.

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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 Exchange 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 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

As part of its continuing efforts to enhance participation on the ArcaEx facility, the PCX is proposing to include an additional processing capability for orders in exchange-listed securities in situations when an order is traded-through by another market's block trade. The Exchange believes that such capability will protect ArcaEx orders from being arbitrated by other market centers.

Currently, PCXE Rule 7.56 (“ITS Trade-Throughs and Locked Markets”) describes the interaction between markets in exchange-listed securities when an order in the ArcaEx Book is traded-through. This rule specifies that block trades³ are generally exempted from the trade-through rule.⁴ Pursuant to the Intermarket Trading System (“ITS”) Plan and PCXE rules, an ETP Holder that trades through another market with a block trade is obligated to send a commitment to the market center it traded through at the block price, unless one of the inapplicability conditions apply.⁵

According to the PCX, the rules permit away markets to send commitments to execute against ArcaEx superior quotes/prices after the away market trades through ArcaEx at inferior block prices. Specifically, an away market may send orders to execute at the superior ArcaEx price during the time period after the away market executes a block trade through ArcaEx, but before it sends the required ITS commitment to trade in response to the block trade-through. According to the Exchange, this enables away markets to execute at ArcaEx’s superior price in order to arbitrage against the inferior block price.

An example of this scenario under the current rules is as follows:

- ArcaEx’s best bid is 7,000 @ \$41.50.
- An away market puts up a block trade in the same symbol for 10,000 @ \$41.25.
- In the intervening timeframe before the away market sends a commitment @ \$41.25, away market participants send sell orders to execute against ArcaEx’s quote

³ See PCXE Rule 7.57 (“Block Trade Policy”). Block trades are trades in excess of 10,000 shares or \$200,000; effected at a price outside the bid or offer displayed from another ITS participating market center; and involves either a cross of block size or any other transaction of block size that is not the result of an execution at the current bid or offer on the Corporation.

⁴ See PCXE Rule 7.56, Commentary .01.

⁵ See PCXE Rule 7.57(c) (creating carve outs to the obligation to send commitments).

@ \$41.50 and subsequently trade @ \$41.25 thereby arbitraging the \$0.25 spread and taking advantage of ArcaEx's superior price.

The Exchange believes that the "Don't Arb Me" modifier is designed to protect better-priced ArcaEx orders from being taken advantage of in these circumstances. The new modifier would, in the instance of a block trade-through, immediately re-price the ArcaEx order at the block price. The order would then be displayed in the ArcaEx book pursuant to PCXE Rule 7.36 and assigned a new time, price priority as of the time of each reposting. The example below is an illustration of how the "Don't Arb Me" modifier will operate:

- Client sends an order to Buy 7,000 @ \$41.50 with the Don't Arb Me modifier.
- ArcaEx displays Buy 7,000 @ \$41.50.
- Away market sends a block trade to the tape in the same symbol for 10,000 @ \$41.25.
- ArcaEx immediately cancels the buy 7,000 @ \$41.50 and posts 7,000 @ \$41.25 with new time priority.
- An order is submitted to ArcaEx that trades with the 7,000 Buy order (@ 41.25).

The Exchange believes that the implementation of the "Don't Arb Me" modifier will facilitate enhanced order interaction and foster price competition. According to the Exchange, the proposal promotes increased efficiency and effectiveness in its market operation, and enhances the investment choices available to investors over a broad range of trading scenarios. The Exchange notes that the "Don't Arb Me" modifier was created in response to ArcaEx participants' requests for additional functionality to deal with the problems described above.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,⁶ in general, and further the objectives of Section 6(b)(5) of the Act,⁷ in particular, because it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanisms of a free and open market and a national market system, and to protect investors and the public interest. In addition, the Exchange believes that the proposed rule change is consistent with provisions of Section 11A(a)(1)(B)⁸ of the Act, which states that new data processing and communications techniques create the opportunity for more efficient and effective market operations.

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

Written comments were neither solicited nor received with respect to the proposed rule change.

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

⁶ 15 U.S.C. 78f(b).

⁷ 15 U.S.C. 78f(b)(5).

⁸ 15 U.S.C. 78k-1(a)(1)(B).

it finds such longer period to be appropriate and publishes its reasons for so finding or (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. 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>);
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PCX-2004-49 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.

All submissions should refer to File Number SR-PCX-2004-49. 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 inspection and copying in the Commission's Public Reference Room. Copies of the filing also will be available for inspection and copying at the principal office of the PCX. 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-PCX-2004-49 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.⁹

Margaret H. McFarland
Deputy Secretary

⁹ 17 CFR 200.30-3(a)(12).