

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50064; File No. SR-PCX-2003-64)

July 22, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment Nos. 1 and 2 thereto by the Pacific Exchange, Inc. Relating to Facilitation Crosses

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 20, 2003, the Pacific Exchange, Inc. (“PCX” or “Exchange”) 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. On July 7, 2004, and July 15, 2004, respectively, the Exchange filed Amendment Nos. 1 and 2 to the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

PCX is proposing to modify its facilitation crossing procedures in several respects in order to ensure that the customer side of a facilitation order will be executed if it is priced at or between quoted markets. Among other things, the proposal would also increase to 40% the guaranteed percentage of the customer order that a Floor Broker is entitled to cross at the quoted market. The text of the proposed rule change is set forth below. Proposed new language is italicized and proposed deletions are in brackets.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letters from Mai S. Shiver, Acting Director/Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission,

Rules of the Board of Governors of the Pacific Exchange, Inc.

Rule 6

Options Trading

"Crossing" Orders and Stock/Option Orders

Rule 6.47 (a) – No change.

(b) **Facilitation Procedure.** **[Crossing of Facilitation Orders.]** The Facilitation Procedure is a process by which a [A] Floor Broker who holds an order for a [public] customer [or a broker-dealer] (“[c]Customer [o]Order”) and an order for the proprietary account of an OTP Holder or OTP Firm or an organization under common control with a Lead Market Maker “LMM” that is representing that customer (the “[f]Facilitation [o]Order”) may cross those orders [only if the following procedures and requirements are followed]. The Floor Broker may do so by following the Facilitation Procedure outlined in this subsection (b) of this Rule. The Floor Broker must be willing to facilitate the entire size of the Customer Order entered via the Facilitation Procedure.

(1) The size of the [c]Customer [o]Order subject to facilitation must be at least fifty contracts. Orders for less than fifty contracts may be facilitated pursuant to this rule but are not subject to the firm guarantees of subsections (4) through (6) of this Rule [below pertaining to firm guarantees] and therefore must satisfy all orders in the book and orders represented in the trading crowd (affording the trading crowd a reasonable period of time to respond) before the floor broker may cross the order.

(2) The option order tickets for both the [f]Facilitation [o]Order and the [c]Customer [o]Order must display all of the terms of such orders, including any contingencies involving, and all

related transactions in, either options or underlying or related securities. The Floor Broker must disclose all securities that are components of the [c]Customer [o]Order.

(3) The Floor Broker must request bids and offers for all components of the [c]Customer [o]Order, including the size of the order, but does not have to specifically request a “facilitation market.” Once the trading crowd has been afforded a reasonable time to provide a quote, the quote will remain in effect only for such time as is necessary for the Floor Broker to immediately vocalize the Customer Order. [and clearly disclose his intention to execute a facilitation cross transaction to the trading crowd. Once the trading crowd has provided a quote, it will remain in effect until: (A) a reasonable amount of time has passed, or (B) there is a significant change in the price of the underlying security, or (C) the facilitation market has been improved. (The term "significant change" will be interpreted on a case-by-case basis by two Trading Officials or the Exchange based upon the extent of recent trading in the option and in the underlying security, and any other relevant factors.)]

(4) In response to the trading crowd’s quoted market, the Floor Broker may immediately consummate the facilitation cross if: (i) he or she immediately bids (offers) a price on the Customer Order that is on or inside the quoted market (“Facilitation Price”) provided by the trading crowd in response to the Floor Broker’s request for a market and (ii) satisfies all other contingencies associated with the Customer Order. After satisfying any orders for the account of persons who are not OTP Holders or OTP Firms of the Exchange pending at the Facilitation Price, the Floor Broker may facilitate up to forty percent (40%) of the remaining Customer Order against the Facilitation Order at the Facilitation Price and must allow any other members of the

have been incorporated in this Notice.

trading crowd interested in trading at the facilitation price to execute the remaining sixty percent (60%) or more of the Customer Order. The allocation of the remaining Customer Order will be made on a (i) size pro-rata basis (the percentage of the orders that is the ratio of the size of the offers (bids) to the total size of the offers (bids) as described in 6.75(f)(6)); or (ii) equal basis (in the case of identical offers (bids) as described in PCX Rule 6.75(c)) where the floor broker's bid (offer) improved the crowd's price in response to the request for a market. If after providing the crowd reasonable time to execute the remaining 60% of the Customer Order any amount of the Customer Order remains, the Floor Broker must fill the remainder of the Customer Order by executing it against the Facilitation Order at the Facilitation Price. [Once a market has been established and all public customer orders represented in the trading crowd have been satisfied, the Floor Broker may cross:

(A) forty percent (40%) of any remaining contracts at a price between the trading crowd's quoted market (e.g., if the trading crowd's quoted market is 2.10 - 2.50, and the Floor Broker is representing a customer order to buy 1000 contracts, then the Floor Broker may cross 40% of 1000 at any 2.25 or any other improved price); or

(B) twenty-five percent (25%) of the contracts at the trading crowd's best bid or offer (e.g., if the trading crowd's quoted market is 2.10 - 2.50, and the Floor Broker is representing a customer order to buy 1000 contracts, then the Floor Broker may cross 25% of 1000 at the trading crowd's offer).]

(5) If the trading crowd does not provide a bid and offer for all components of the Customer Order in response to the Floor Broker's request within a reasonable period of time, for the purposes of this rule, either: (i) the quoted market disseminated by the Exchange prior to the

commencement of the Facilitation Procedure will constitute the market quoted by the trading crowd in response to the Floor Broker's request; or (ii) for orders for which there is no disseminated market (such as complex orders), the market for the order will be determined by the disseminated quote for each leg of the transaction prior to the commencement of the Facilitation Procedure. Once the Floor Broker provides a Facilitation Price and can satisfy all of the contingencies associated with the Customer Order, the Customer Order is deemed consummated at the Facilitation Price. After satisfying the orders of any persons who are not OTP Holders or OTP Firms of the Exchange pending at the Facilitation Price, the Floor Broker may facilitate up to forty percent (40%) of the remaining Customer Order against the Facilitation Order at the Facilitation Price and must allow any other member of the trading crowd interested in trading at the facilitation price to execute the remaining sixty percent (60%) or more of the Customer Order. After providing the crowd reasonable time to execute the remaining 60% of the Customer Order, the Floor Broker must fill the remainder of the Customer Order by executing it against the Facilitation Order at the Facilitation Price. [If the facilitation trade occurs at the LMM's quoted bid or offer in their allocated issue, then the LMM's guaranteed participation level shall apply only to the number of contracts remaining after all public customer orders and the firm facilitation order being represented by the Floor Broker have been satisfied pursuant to this rule. However, the total amount of participation that any firm and/or LMM may receive, as a guarantee, may not exceed, in the aggregate, forty percent (40%) of the customer order. If the trade occurs at a price other than the LMM's quoted bid or offer, the LMM is entitled to no guaranteed participation.]

(6) If the facilitation trade occurs at the LMM's quoted bid or offer in their allocated issue and the Floor Broker takes less than forty percent (40%) of the trade, then the LMM may elect to accept either: (i) a guaranteed participation level of forty percent (40%) minus the Floor Broker's allocation percentage, or (ii) to participate in the pro-rata allocation on a non-guarantee participation level. If the trade occurs at a price other than the LMM's quoted bid or offer, the LMM is entitled to no "guaranteed" participation. Nothing in this rule is intended to prohibit a Floor Broker or LMM from trading more than their percentage entitlements if the other members of the trading crowd do not choose to trade the remaining portion of the order. [The OTP
Holders or OTP Firms of the trading crowd who established the facilitation market will have priority over all other non-public customer orders that were not represented in the trading crowd at the time that the facilitation market was established and will maintain priority over non-customer orders except for orders that improve the bid or offer. A Floor Broker who is holding a customer order and a facilitation order and who calls for a facilitation market will be deemed to be representing both the customer order and the facilitation order, so that the customer order and the facilitation order will also have priority over all other non-public customer orders that were not being represented in the trading crowd at the time that the facilitation market was established.]

(c) – No change.

(d) – Trading Crowd Opportunity to Respond. Except as provided in subparagraph (b) of this rule relating to the Facilitation Procedure for Customer Orders of at least 50 contracts, Floor Brokers are cautioned that they must allow OTP Holder or OTP Firm represented in the trading crowd a reasonable period in which to respond to the bid and/or offer prior to consummating the

cross transaction. A reasonable period will not be defined in terms of specific time limit.

However, an obvious attempt to execute a cross in an uninterrupted sequence with the announcement of the bid and offer is deemed to be a violation of Rule 6.47 and Rule 6.73, and grounds for objection to the cross transaction.

(e)–(f) – No change.

Commentary:

.01 The term "[public] customer of an OTP Holder or OTP Firm" shall mean, in connection with Rule 6.62(i) and 6.47, a customer that is neither an OTP Holder or OTP Firm nor a broker/dealer.

.02 When accepting a bid or offer made on behalf of a [public] customer, all contingencies of the [public] [c]Customer [o]Order must be satisfied by the accepting OTP Holder or OTP Firm.

.03 – No change.

.04 Where a related transaction must be effected in another market, that transaction must be effected prior to [effecting] the options transaction.

.05 – No change.

.06 [The Exchange has determined that deliberate misrepresentation of an order will subject an OTP Holder or OTP Firm to disciplinary action.] It will be a violation of a Floor Broker's duty to use due diligence in representing its Customer Order if a Floor Broker does not employ the Facilitation Procedure on the PCX immediately upon receipt on the PCX of the order that the OTP Holder or OTP Firm wishes to have executed as a facilitation cross.

.07 It will be a violation of an OTP Holder or OTP Firm's duty of best execution to its customer if it were to cancel a Facilitation Order to avoid execution of the order at a better price. The availability of the Facilitation Procedure does not alter an OTP Holder or OTP Firm's best

execution duty to get the best price for its customer. Accordingly, while facilitation orders can be cancelled prior to a trading crowd providing quotes in response to a request for a market, if an OTP Holder or OTP Firm were to cancel a Facilitation Order when there was a superior price available on the Exchange and subsequently re-enter the Facilitation Order at the same Facilitation Price after the better price was no longer available without attempting to obtain that better price for its customer, there would be a presumption that the OTP Holder or OTP Firm did so to avoid execution of its Customer Order in whole or in part by other brokers at the better price.

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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. PCX 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 facilitation crossing procedure as provided in PCX Rule 6.47(b) allows a Floor Broker who holds an order for a customer and an order for the proprietary account of an OTP (Options Trading Permit) Holder or OTP Firm representing that customer to cross those orders. The Exchange seeks to amend its facilitation crossing rules in order to ensure that the customer side of a

facilitation cross will be executed in a facilitation cross if it is priced at or between markets quoted in response to a request for a market. Among other things, the proposal would also increase to 40% the guaranteed percentage of the customer order that a Floor Broker is entitled to cross at the quoted market. The Exchange represents that the proposed amendment to its facilitation crossing rules makes the Exchange's crossing rules more competitive and generally consistent with the crossing rules of other options exchanges.⁴ Accordingly, the Exchange proposes to make the following changes to its rule:

Size of the Customer Order and Applicability

The current rule specifies that the size of the customer order subject to facilitation generally must be at least fifty contracts. The proposed rule change clarifies the rule's provision for orders for fewer than fifty contracts to state that such orders may be facilitated pursuant to the rule, but are not subject to the firm guarantees of the facilitation crossing rule and therefore must satisfy all orders in the book and orders represented in the trading crowd (affording the trading crowd a reasonable period of time to respond) before the Floor Broker may cross the order. The Exchange also seeks to expand the newly amended rule ("Facilitation Procedure") to an organization under common control with a Lead Market Maker ("LMM") that is representing the customer order. The proposed rule change would also amend the rule so that the Facilitation Procedure applies only to a cross of a proprietary order of an OTP Holder, OTP Firm, or organization under common control with an LMM with an order of a customer ("Customer Order"), meaning a customer that is not an OTP Holder, an OTP Firm or a broker-dealer.⁵

⁴ See, e.g., International Stock Exchange Rule 716.

⁵ Telephone conversation between Mai S. Shiver, Director/Senior Counsel, PCX, and Ira L. Brandriss, Assistant Director, et al., Division, Commission, July 22, 2004.

Vocalization Requirements

Currently, PCX Rule 6.47(b)(3) requires a Floor Broker to clearly disclose all components of a Customer Order and his or her intention to execute a facilitation cross transaction in the trading crowd. Once the crowd provides a quote, the quote remains in effect until (i) a reasonable amount of time has passed, (ii) there is a significant change in price of the underlying security, or (iii) the facilitation market has been improved. The Exchange seeks to amend the rule to eliminate the requirement that the Floor Broker specifically request a “facilitation market” and add the requirement that in calling for a market, the Floor Broker would have to reveal the size of the transaction in addition to the components of the order. The Exchange believes that the disclosure of the size of the transaction, including any components, will provide the crowd more information relevant to the decision-making process and enable the crowd to respond more expeditiously than disclosure of the fact that the Floor Broker is calling for a facilitation market.⁶

Facilitation Procedure and Allocation

PCX Rule 6.47(b)(4) provides the participation percentages to which a Floor Broker representing a facilitation cross is entitled. The rule currently provides that once a market has been established and all public customer orders represented in the trading crowd have been satisfied, the Floor Broker may cross either (i) 40% of any remaining contracts at a price between the trading crowd’s quoted market, or (ii) 25% of the contracts at the trading crowd’s best bid or offer.

⁶ According to the PCX, in eliminating the requirement that the Floor Broker specifically request a facilitation market, the proposed Facilitation Procedure reflects the Exchange’s facilitation crossing rules that existed before the Exchange amended its current rules in May 2000. Telephone conversation between Mai S. Shiver, Director/Senior Counsel, PCX, and Ira L. Brandriss, Assistant Director, *et al.*, Division, Commission, July 14, 2004. See also Securities Exchange Act Release No. 42848 (May 26, 2000), 65 FR 36206 (June 7, 2000) (PCX 99-18).

The Exchange seeks to modify this rule in two respects: (i) to clearly delineate a Facilitation Procedure and (ii) to modify the guaranteed participation levels of the Floor Broker providing the facilitation order. The Exchange proposes that in response to the trading crowd's quoted market, the Floor Broker may immediately provide a bid (offer) price for the Customer Order, so long as the Floor Broker's price ("Facilitation Price") is on or inside the quoted market provided by the trading crowd in response to the Floor Broker's request for a market. As proposed, once the Floor Broker provides a Facilitation Price and can satisfy all of the contingencies associated with the Customer Order, the Customer Order is deemed consummated at the Facilitation Price.

Once the facilitation process described above is achieved, the Exchange proposes to allocate the Customer Order in the following way: After first satisfying any orders for the account of persons who are not OTP Holders or OTP Firms pending at the Facilitation Price, the Floor Broker may facilitate up to 40% of the remaining Customer Order against the facilitation order at the Facilitation Price and must allow any other member of the trading crowd interested in trading at the

Facilitation Price to execute the remaining 60% or more of the Customer Order. The allocation of the remaining Customer Order would be made on (i) a size pro-rata basis (the percentage of the orders that is the ratio of the size of the offers (bids) to the total size of the offers (bids) as described in 6.75(f)(6)); or (ii) an equal basis (in the case of identical offers (bids) as described in PCX Rule 6.75(c)) where the Floor Broker's bid (offer) improved the crowd's price in response to the request for a market. If after providing the crowd reasonable time to execute the remaining 60% of the Customer Order any amount of the Customer Order remains, the Floor Broker would be required to fill the remainder of the Customer Order by executing it against the Facilitation Order at the Facilitation Price.

The Exchange also proposes to add new PCX Rule 6.47(b)(5) to state that if the trading crowd does not provide a bid and offer for all components of the Customer Order in response to the Floor Broker's request within a reasonable period of time, the "market quote" for the purpose of this rule will be: (i) the quoted market disseminated by the Exchange prior to the commencement of the Facilitation Procedure, or (ii) for orders for which there is no disseminated market, the market for the order will be determined by the disseminated quote for each leg of the transaction prior to the commencement of the Facilitation Procedure. Once the Floor Broker provides a Facilitation Price and can satisfy all of the contingencies associated with the Customer Order, the Customer Order would be deemed consummated at the Facilitation Price. After satisfying the orders of any persons who are not OTP Holders or OTP Firms pending at the Facilitation Price, the Floor Broker would be permitted to facilitate up to 40% of the remaining Customer Order against the Facilitation Order at the Facilitation Price and would be required to allow any other member of the trading crowd interested in trading at the facilitation price to

execute the remaining 60% or more of the Customer Order. After providing the crowd reasonable time to execute the remaining 60% of the Customer Order, the Floor Broker would be required to fill the remainder of the Customer Order by executing it against the Facilitation Order at the Facilitation Price.

Participation of Lead Market Makers

Currently, PCX Rule 6.47(b)(5) provides that if the facilitation trade occurs at the LMM's quoted bid or offer in its allocated issue, then the LMM's guaranteed participation level shall apply only to the number of contracts remaining after all public customer orders and firm facilitation orders being represented by the Floor Brokers have been satisfied. The rule further provides that the total amount of participation that any firm and/or LMM may receive as a guarantee may not exceed 40% of the Customer Order. If the trade occurs at a price other than the LMM's quoted bid or offer, the LMM is entitled to no guaranteed participation.

The Exchange seeks to renumber this rule as proposed PCX Rule 6.47(b)(6) and amend it to provide that if the facilitation trade occurs at the LMM's quoted bid or offer in their allocated issue and the Floor Broker takes less than 40% of the trade, then the LMM may elect either (i) to accept a guaranteed participation level of 40% minus the Floor Broker's allocation percentage, or (ii) to participate in the pro-rata allocation on a non-guarantee participation level. If the trade occurs at a price other than the LMM's quoted bid or offer, the LMM would be entitled to no "guaranteed" participation. The proposed rule would not prohibit a Floor Broker or LMM from trading more than their guaranteed participation levels if the members of the trading crowd do not choose to trade the remaining portion of the order.

Violative Conduct

Current Commentary .06 to PCX Rule 6.47 provides that the Exchange has determined that deliberate misrepresentation of an order will subject an OTP Holder or OTP Firm to disciplinary action. The Exchange seeks to replace this provision with new Commentaries .06 and .07, which expressly define the conduct that the Exchange deems to be in violation of existing Exchange rules. As proposed, new Commentary .06 provides that it will be a violation of a Floor Broker's duty to use due diligence in representing its Customer Order if the Floor Broker does not employ the Facilitation Procedure on the PCX immediately upon receipt on the PCX of the order that the OTP Holder or OTP Firm wishes to have executed as a facilitation cross.

The Exchange also proposes to add Commentary .07, which provides that it will be a violation of an OTP Holder's or OTP Firm's duty of best execution to its customer if it cancels a facilitation order for the purpose of avoiding execution of the order at a better price. The Exchange believes that that the availability of the Facilitation Procedure does not alter an OTP Holder or OTP Firm's best execution duty to get the best price for its customer. Therefore, while facilitation orders can be cancelled prior to obtaining quotes from a trading crowd, an OTP Holder or OTP Firm that (i) cancels a facilitation order when there is a superior price available on the Exchange and (ii) subsequently reenters the facilitation order at the same Facilitation Price after the better price is no longer available and does not attempt to obtain that better price for its customer is presumed to have acted in violation of his or her duty of best execution.

2. Statutory Basis

The Exchange states that the basis under the Act for the proposed rule change is the requirement under Section 6(b)(5) of the Act⁷ that an exchange have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and 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 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 on the proposed rule change were neither solicited nor 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 (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.

⁷ 15 U.S.C. 78f(b)(5).

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
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PCX-2003-64 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-2003-64. 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 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-PCX-2003-64 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.⁸

Margaret H. McFarland
Deputy Secretary

⁸ 17 CFR 200.30-3(a)(12).