

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50191; File No. SR-PCX-2004-78)

August 13, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc. Relating to Priority and Order Allocation Procedures for PCX Plus

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 August 10, 2004, 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 PCX. 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 PCX proposes to amend PCX Rule 6.76 (Priority and Allocation Procedures of PCX Plus) to eliminate the requirement that inbound marketable Broker Dealer orders will route to Floor Broker Hand Held Terminals in some trading scenarios in lieu of receiving immediate electronic executions. The Exchange also proposes to eliminate Electronic Book Execution pursuant to PCX Rule 6.76(b)(4). Below is the text of the proposed rule change. Proposed new language is *italicized*; proposed deletions are in [brackets].

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Rule 6

Options Trading

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Priority and Order Allocation Procedures

Rule 6.76. The rules of priority and order allocation procedures set forth in this Rule 6.76 will apply to option issues designated by the Exchange to be traded in PCX Plus. The maximum size of an inbound order that may be eligible for execution on PCX Plus pursuant to Rule 6.76(b) (“the Maximum Order Size”) will be initially established by the LMM in the issue, subject to the approval of the Exchange. Any request by the LMM for changes to the Maximum Order Size must be accompanied by a verified statement indicating the business reason for the change and the estimated duration of such change. Such requests must be approved by two Floor Officials, whose approval must be further ratified by the Exchange. An LMM is prohibited from requesting changes to the Maximum Order Size in order to manipulate the operation of PCX Plus or for any anti-competitive purposes.

(a) – No Change.

(b) PCX Plus Executions. This subsection (b) addresses situations in which orders or Quotes with Size are executed through PCX Plus.

(1) An inbound order that is marketable will be immediately executed against bids and offers in the Consolidated Book, unless [one of the following conditions applies:]

[(A)] the size of the inbound order exceeds the Maximum Order Size established pursuant to Rule 6.76; or

(B) the inbound order is for the account of a Firm or Non-OTP Holder or OTP Firm Market Maker and more than 50% of the aggregate trading interest in the Consolidated Book at the execution price is for the account (or accounts) of Public Customers.]

If it does exceed the maximum order size, [the conditions specified in subsections (A) or (B) above apply,] the order will be represented in the trading crowd pursuant to Rule 6.76(d).

(2) An inbound order will be either fully or partially executed as follows:

(A) If more than 40% of the size in the Consolidated Book is comprised of a single Firm or Non-OTP Holder or OTP Firm Market Maker order at the price at which the inbound order would trade[, and such Firm or Non-OTP Holder or OTP Firm Market Maker order was entered less than one minute before the inbound order,] then:

(i) the inbound order will first be matched against all available Public Customer interest in the Consolidated Book;

(ii) the inbound order, if not entirely filled, will then satisfy any available interest based on FIQ status and LMM guaranteed participation pursuant to Rule 6.76(a);

(iii) the inbound order, if not entirely filled, will then match, on a size pro rata basis, with the interest of the Market Makers, Firms and Non-OTP Holder or OTP Firm Market Makers in the Consolidated Book;[provided that the size pro rata share interest of each individual Firm and

each Non-OTP Holder or OTP Firm Market Maker will be limited to 40% of the size of the remaining inbound order; and

(iv) the balance of the order, if any, will then be routed to a Floor Broker Hand Held Terminal.

(B) If the same conditions set forth in subsection (b)(2)(A) above apply but the Firm or Non-OTP Holder or OTP Firm Market Maker order was entered one minute or more before the inbound order, then:

(i) the inbound order will first be matched against all available Public Customer interest in the Consolidated Book;

(ii) the inbound order, if not entirely filled, will then satisfy any available interest based on FIQ status and LMM guaranteed participation pursuant to Rule 6.76(a);

(iii) the inbound order, if not entirely filled, will then match, on a size pro rata basis, with the interest of the Market Makers, Firms and Non-OTP Holder or OTP Firm Market Makers in the Consolidated Book; provided that the size pro rata share interest of each individual Firm and each Non-OTP Holder or OTP Firm Market Maker will be limited to 40% of the size of the remaining inbound order;

(iv) the inbound order, if not entirely filled, will then match, on a size pro rata basis, with all other remaining volume in the Consolidated Book of Firms and Non-OTP Holder or OTP Firm Market Makers who were previously limited to 40%;] and

(iv) the balance of the order, if any, will then be either:

(a) routed to a Floor Broker Hand Held Terminal in the case where the order locks or crosses the NBBO; or

(b) executed at the next available price level based on split-price execution, as provided in subsection (b)(3), below.

If neither of the conditions specified in subsections (a) or (b) apply, and the order is no longer marketable, then such order will be represented in the Consolidated Book.

(b)(3) – No Change.

(b)(4) – Reserved. [Electronic Book Execution. This subsection addresses situations in which Market Makers interact electronically with orders in the Consolidated Book. When a Quote with Size from a Market Maker initiates a trade with the Consolidated Book (the “initiating Quote with Size”), an Electronic Book Execution will occur as follows.

(A) The initiating Quote with Size will immediately execute against the Consolidated Book if the percentage of the transaction involving Public Customer interest (as represented in the Consolidated Book) would comprise no more than 40% of the transaction (e.g., if the initiating Quote with Size is for 20 contracts and the size in the Consolidated Book at the execution price is 50 contracts, six contracts of which are the Public Customer interest ($6 \div 20 = 30\%$), then the initiating Quote with Size for 20 contracts will be executed in full).

(B) If the initiating Quote with Size would effect a transaction against the Consolidated Book and the percentage of the transaction involving Public Customer

interest would comprise more than 40% of the transaction, then the initiating Quote with Size will be processed as follows:

(i) the Market Makers initiating Quote with Size will receive an execution comprising the greater of:

(a) 40% of the Public Customer interest in the Consolidated Book at that price; or

(b) the total size to which the inbound initiating Quote with Size would receive pursuant to a size pro rata allocation.

(ii) the balance of the Consolidated Book at that price will be displayed for three seconds (via a System Alert Message - SAM) to all “Crowd Participants” (as defined in Rule 6.1(b)(38)).

(a) A Floor Broker holding an order for an account in which such broker has an interest, the account of an associated person, or an account with respect to which the Floor Broker or an associated person thereof exercises investment discretion, shall not be eligible for participation in Electronic Book Executions.

(iii) the balance of the Public Customer interest in the Consolidated Book will then be allocated on size pro rata basis to all Crowd Participants, if any, who have entered bids or offers to trade at the execution price within the three seconds provided.

(iv) after the Public Customer interest has been allocated, the initiating Quote with Size will match against all remaining interest in the Consolidated Book. If the initiating Quote with Size does not fill the Consolidated Book, then

all Crowd Participants will be matched on a size pro rata basis with the remaining interest in the Consolidated Book at that price.

(v) if the remaining Quotes with Size are executable at the next price level, they will be matched against the Consolidated Book on a size pro rata basis.]

(b)(5) - (c) – No Change.

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

Currently, PCX Rule 6.76(b) addresses the situations in which orders or Quotes with Size³ are executed through PCX Plus. Today, when an inbound order is for the account of a Firm⁴ or Non-OTP Holder Market Maker⁵ and more than 50% of the aggregate trading interest in the Consolidated Book⁶ at the execution price is for the account (or accounts) of

³ See PCX Rule 6.1(b)(33).

⁴ See PCX Rule 6.1(b)(36).

⁵ See PCX Rule 6.1(b)(35).

⁶ See PCX Rule 6.1(b)(37).

Public Customers⁷, the order is not eligible to be immediately executed on PCX Plus. Instead, such orders are routed to Floor Broker Hand Held terminals for manual representation in the trading crowd at which time they may receive full or partial execution based on the price and size disseminated at that time. According to the PCX, this, however, is not necessarily the price and size disseminated at the time of order entry because the price and size disseminated at the time the order is represented in the trading crowd may have changed from the time the order was entered. As a result, a Firm or Non-OTP Holder Market Maker may not know whether its order has been fully or partially executed and at what price until seconds after it sends the order to the Exchange. The PCX believes that this lack of certainty creates a disincentive for a Firm or Non-OTP Holder Market Maker to send orders via PCX Plus. The PCX also believes that removing the impediment and allowing Firm and Non-OTP Market Maker orders to immediately execute on PCX Plus would enable the Exchange to execute orders faster and create greater efficiencies and price transparency in the marketplace. To further provide the Exchange with the ability to execute orders faster, the proposed rule change would remove the restrictions on an order entered by a Firm or Non-OTP Holder or OTP Firm Market Maker less than one minute before the inbound order. In addition, the proposed rule change would eliminate the 40% participation limitation currently placed on a Firm, Non-OTP Holder or OTP Firm Market Maker for an inbound order that is not entirely filled.

In conjunction with this proposed amendment to PCX Rule 6.76(b)(1) and (b)(2), the Exchange also proposes to eliminate the Electronic Book Execution rules set forth in PCX

⁷ See PCX Rule 6.1(b)(29).

Rule 6.76(b)(4) that prevent PCX Market Makers from immediately executing orders against the Consolidated Book. The PCX believes that eliminating these rules would give PCX Market Makers the same access to the Consolidated Book that a Firm or Non-OTP Holder Market Maker would have under the proposed rules, thereby eliminating any potential biases that a PCX Market Maker might encounter when using PCX Plus. The PCX believes that allowing PCX Market Makers to immediately execute against the Consolidated Book would also improve the speed of executions at the PCX and would add liquidity to the PCX's markets and, as a result, benefit the investing public.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act⁸ in general, and furthers the objectives of Section 6(b)(5) of the Act⁹ in particular, because it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of change, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

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.

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-2004-78 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-2004-78. 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such 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-2004-78 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.¹⁰

Margaret H. McFarland
Deputy Secretary

¹⁰ 17 CFR 200.30-3(a)(12).