

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50473; File No. SR-PCX-2003-64)

September 29, 2004

Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendments No. 1 and 2 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendments No. 3, 4, and 5 Thereto Regarding Facilitation Crossing Procedures

I. Introduction

On November 20, 2003, the Pacific Exchange, Inc. (“PCX” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to modify the Exchange’s facilitation crossing procedures in several respects. On July 7, 2004, and July 15, 2004, respectively, the Exchange filed Amendments No. 1 and 2 to the proposed rule change.³ The proposed rule change as amended by Amendments No. 1 and 2 was published for comment in the Federal Register on July 29, 2004.⁴ The Commission received no comments on the proposal, as amended. On September 24, 2004, the Exchange submitted Amendment No. 3 to the proposal.⁵ On September 29, 2004, the Exchange submitted Amendment No. 4 and

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, dated July 6, 2004, and July 14, 2004.

⁴ See Securities Exchange Act Release No. 50064 (July 22, 2004), 69 FR 45360 (“Notice”).

⁵ See letter from Mai S. Shiver, Director/Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division, Commission, dated September 23, 2004 (“Amendment No. 3”). In Amendment No. 3, the Exchange expanded the types of orders eligible for crossing with a Customer Order to include orders for the proprietary account of an organization under common control with a Market Maker that is representing the customer. The version of this provision published in the Notice applied only to orders for the proprietary account of an

Amendment No. 5 to the proposed rule change.⁶ This order approves the proposed rule change and Amendments No. 1 and 2, grants accelerated approval of Amendments No. 3, 4, and 5, and solicits comments on Amendments No. 3 and 5.

II. Discussion of the Proposed Rule Change

Current PCX Rule 6.47(b), concerning the crossing of facilitation orders, permits 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 that is representing that customer (“Facilitation Order”) to cross those orders, provided that specified procedures and requirements are met. Among other things, before executing the cross, the Floor Broker must request from the trading crowd bids and offers for all components of the customer order and clearly disclose his or her intention to execute a facilitation cross transaction. With respect to customer orders of 50 contracts or more, the current rule further 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.

The proposed rule change would amend Rule 6.47(b), to be newly entitled “Facilitation Procedure,” in several ways. Whereas the current rule defines a “customer order” subject to

organization under common control with a Lead Market Maker (“LMM”) that is representing the customer. Amendment No. 3 also clarified the rule with respect to allocation of the portion of the Customer Order remaining after the Floor Broker executes its guarantee in certain situations, and made technical and stylistic changes to the rule text.

⁶ See letters from Mai S. Shiver, Director/Senior Counsel, PCX, to Nancy J. Sanow, Assistant Director, Division, Commission, dated September 28, 2004 (“Amendment No. 4”) and September 29, 2004 (“Amendment No. 5”). Amendment No. 4 was a technical amendment correcting typographical errors in the proposed rule text, and is not required to be noticed for comment. In Amendment No. 5, the Exchange proposed to make the effective date of the proposal October 29, 2004 in order to allow the Exchange to provide proper notice and education to the Exchange OTP Holders and OTP Firms that are affected by the rule change.

facilitation to include orders of broker-dealers, under the proposal, the facilitation procedure would apply only to orders of public customers.⁷ The proposed rule change would add a requirement that in calling for the crowd's market, the Floor Broker must include the size of the order, but would eliminate the requirement that the Floor Broker disclose his intention to execute a facilitation cross. The proposal would also permit the Floor Broker to immediately consummate the facilitation cross in response to the trading crowd's quoted market if he or she immediately bids or offers a price on the customer order that is on or inside the quoted market ("Facilitation Price") provided by the trading crowd. As revised by Amendment No. 3, the proposal would also expand the rule to allow a Floor Broker to cross a Customer Order with an order for the proprietary account of an organization under common control with a Market Maker that is representing that customer.⁸

Further, the proposal would (a) increase to 40% the guaranteed percentage of a Customer Order that a Floor Broker is entitled to cross at the quoted market, and (b) obligate the Floor Broker to fill any portion of the customer order that remains unexecuted after the Floor Broker has provided the trading crowd an opportunity to execute the remainder of the order. Specifically, 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 would be permitted to facilitate up to 40% of the remaining contracts in the Customer Order against the Facilitation Order at the Facilitation Price. The Floor Broker 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.

⁷ See Notice at note 5 and accompanying text. Such orders would be defined in the rule as "Customer Orders."

⁸ See supra note 5.

The remaining 60% would be allocated among the members interested in trading at the Facilitation Price on a size pro-rata basis or, in the case of identical offers or bids (where the Floor Broker's offer or bid improved the crowd's price in response to the request for a market), on an equal basis. If any portion of the Customer Order remains after providing the crowd reasonable time to execute the remaining 60%, 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), which states 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 either (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, a quote that is determined by the disseminated quote for each leg of the transaction prior to the commencement of the Facilitation Procedure. As clarified in Amendment No. 3, the 60% of the Customer Order remaining after the Floor Broker executes the 40% guarantee in such a situation would be allocated on an equal basis among any members of the crowd interested in trading at the Facilitation Price.

The proposal would renumber former PCX Rule 6.47(b)(5) as 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 its 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 without a guaranteed participation level. If the trade occurs at a price other than the LMM's quoted bid or offer, the LMM would

not be entitled to a guaranteed participation. A Floor Broker or LMM would not be prohibited 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.

The proposed rule change would revise Commentary .06 to PCX Rule 6.47 to provide 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.

Finally, the proposed rule change would clarify facilitation crossing procedures for orders of less than 50 contracts, which are not subject to the guarantees set forth in the rule. The proposal would establish that, when facilitating such orders, the Floor Broker must satisfy all orders in the book and all orders represented in the trading crowd (affording the trading crowd a reasonable period of time to respond to the Customer Order) before the Floor Broker may cross the Customer Order.

III. Commission Findings and Order Granting Approval

After careful consideration, the Commission has determined to approve the proposed rule change, as amended.⁹ For the reasons discussed below, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and

⁹ In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

regulations thereunder applicable to a national securities exchange. Specifically, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b)(5) of the Act,¹⁰ which requires, among other things, that an exchange's rules be designed 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.

The proposed rule change sets forth a number of amendments to the procedures for the execution of facilitation crossing transactions on the Exchange, and would also increase the guaranteed percentage to which a Floor Broker is entitled when facilitating a Customer Order at the quoted market. The Commission believes that these changes are generally consistent with rules in place variously at other exchanges or otherwise constitute reasonable modifications to the Exchange's procedures. In particular, the Commission notes that the increase in the percentage that the Floor Broker is entitled to facilitate at the quoted market would not exceed 40% of an order. The Commission has previously found that participation guarantees of as much as 40% of an order in options trading are not inconsistent with statutory standards of competition and free and open markets.¹¹

The Commission further notes that the proposed rule change also would require a Floor Broker to fill the remainder of the Customer Order that is not filled by the trading crowd by executing it against the Facilitation Order, thus ensuring that the Customer Order will be

¹⁰ 15 U.S.C. 78f(b)(5).

¹¹ See, e.g., Securities Exchange Act Releases No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) at 11398; and No. 43100 (July 31, 2000), 65 FR 48778 (August 9, 2000) at notes 96-99 and accompanying text.

executed at or between quoted markets.¹² The proposed rule change also clarifies the Exchange's facilitation procedures by setting forth explicit provisions regarding the method for allocating the contracts remaining after the Floor Broker executes his or her guaranteed percentage. Finally, the new commentaries regarding Floor Brokers' duties of best execution and due diligence contribute to the clarity of the facilitation rules by expressly defining violative conduct.

The Commission finds good cause for approving Amendments No. 3 and 5 to the proposed rule change prior to the thirtieth day after the amendment is published in the Federal Register, pursuant to Section 19(b)(2) of the Act.¹³ With respect to the types of orders that may be Facilitation Orders, Amendment No. 3 eliminated a distinction between orders for the proprietary accounts of organizations under common control with LMMs and orders for the proprietary accounts of organizations under common control with Market Makers, and thus enhanced the proposed rule change. Amendment No. 3 also strengthened the proposal by clarifying the method of allocation of the remaining 60% of a Customer Order in a situation where the crowd had not provided a response to Floor Broker's request for a market. Finally, Amendment No. 3 made a few minor technical and stylistic changes to the proposed rule text. In Amendment No. 5, the Exchange proposed to make the effective date of the proposal October 29, 2004 in order to allow the Exchange to provide proper notice and education to the Exchange OTP Holders and OTP Firms that are affected by the rule change. Acceleration of Amendments No. 3 and 5 will permit the Exchange to implement the proposal in an expeditious

¹² The Exchange represents that any portion of a Customer Order executed pursuant to this rule would not be executed at a price inferior to the national best bid or offer. Telephone conversation between Mai S. Shiver, Director/Senior Counsel, PCX, and Ira L. Brandriss, Assistant Director, Division, Commission, September 29, 2004.

¹³ 15 U.S.C. 78s(b)(2).

manner. The Commission, therefore, believes that good cause exists, consistent with Section 6(b)(5)¹⁴ and Section 19(b)¹⁵ of the Act, to accelerate approval of Amendment No 3.

IV. Solicitation of Comments Concerning Amendment No. 3

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 3, including whether it 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

¹⁴ 15 U.S.C. 78f(b)(5).

¹⁵ 15 U.S.C. 78s(b).

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].

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁶ that the proposed rule change (File No. SR-PCX-2003-64) and Amendments No. 1 and 2 thereto are approved, and that Amendments No. 3, 4 and 5 thereto are approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Margaret H. McFarland
Deputy Secretary

¹⁶ 15 U.S.C. 78s(b)(2).

¹⁷ 17 CFR 200.30-3(a)(12).