

necessary or appropriate in furtherance of the purposes of the Act, as amended.

*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.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

The foregoing proposed rule change has become effective pursuant to Section 19(b)(3)(A)(iii)<sup>8</sup> of the Act and subparagraph (f)(3) of Rule 19b-4 thereunder<sup>9</sup> because it is concerned solely with the administration of Nasdaq. At any time within 60 days of the filing of a rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

**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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2005-108 on the subject line.

*Paper Comments*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2005-108. 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 NASD. 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-NASD-2005-108 and should be submitted on or before October 20, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Jonathan G. Katz,**  
*Secretary.*

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-52497; File No. SR-PCX-2005-90]

**Self-Regulatory Organizations; Pacific Exchange, Inc.; Order Granting Approval of Proposed Rule Change and Amendment No. 1 Thereto and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2 to the Proposed Rule Change To Amend the Certificate of Incorporation of PCX Holdings, Inc., PCX Rules, and the Bylaws of Archipelago Holdings, Inc. in Relation to the Acquisition of PCX Holdings by Archipelago Holdings**

September 22, 2005.

**I. Introduction**

On August 1, 2005, the Pacific Exchange, Inc. ("PCX" or the "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, as amended ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend the certificate of incorporation of PCX Holdings, Inc. ("PCXH"), the PCX rules, and the bylaws of Archipelago Holdings, Inc.

("Archipelago") in relation to the acquisition of PCXH by Archipelago. On August 10, 2005, the Exchange filed Amendment No. 1 to the proposed rule change. The proposed rule change, as amended, was published for comment in the **Federal Register** on August 18, 2005.<sup>3</sup> The Commission received one comment on the proposal.<sup>4</sup> On September 16, 2005, the Exchange filed Amendment No. 2 ("Amendment No. 2") to the proposed rule change.<sup>5</sup> This order approves the proposed rule change, grants accelerated approval to Amendment No. 2 to the proposed rule change, and solicits comments from interested persons on Amendment No. 2.

**II. Description of the Proposal**

On January 3, 2005, PCXH, Archipelago and New Apple Acquisitions Corporation ("Merger Sub"), a newly formed wholly owned subsidiary of Archipelago, entered into an Agreement and Plan of Merger,<sup>6</sup>

<sup>3</sup> See Securities Exchange Act Release No. 52249 (August 12, 2005), 70 FR 48611 ("Notice").

<sup>4</sup> See electronic mail sent to the Division of Enforcement and the Division of Market Regulation on September 13, 2005 from "A Concerned Stakeholder."

<sup>5</sup> In Amendment No. 2, the Exchange: (1) Revised its Form 19b-4 to reflect actions by the stockholders of PCXH approving the Merger Agreement (as defined below) on September 13, 2005, thereby completing the last necessary corporate action; (2) made certain technical, non-substantive corrections to the text of the proposed rule change; (3) clarified the scope of the term "real-time market surveillance" in its discussion of the scope of the regulatory agreement between PCX and NASD pursuant to Rule 17d-2 under the Act; (4) clarified the relationship between Archipelago and Wave Securities, L.L.C. ("Wave"); Archipelago and Terra Nova Trading, L.L.C. ("Terra Nova"); Terra Nova and TAL Financial Services, LLC ("TAL"); and Archipelago and White Cap Trading LLC ("White Cap") in relation to its requests for exceptions from PCXH's ownership and voting limitations included in the Notice; (5) provided that the temporary exception it requested for Wave in the Notice would be subject to a condition that Archipelago continue to maintain and comply with its existing information barriers; (6) included a request for a temporary exception from the PCXH ownership and voting requirements for the "inbound routing" function of its wholly owned subsidiary Archipelago Trading Services, Inc. ("Arca Trading") and the related clearing function performed by Archipelago Securities, L.L.C. ("Archipelago Securities"), subject to certain conditions; (7) requested an exception on a 60-day pilot basis for Archipelago to continue to own and operate an alternative trading system ("ATS") for the trading of over-the-counter bulletin board securities not traded on any exchange; (8) requested an exception on a pilot basis until the earlier of (a) 60 days and (b) the closing of the pending merger between Archipelago and the New York Stock Exchange, Inc. ("NYSE") for Archipelago to be able to continue to own and operate, through Archipelago Securities, a service that provides direct connectivity to the NYSE through DOT access; and (9) requested accelerated approval of Amendment No. 2.

<sup>6</sup> On July 22, 2005, PCXH, Archipelago and Merger Sub amended and restated the Original

Continued

<sup>8</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>9</sup> 17 CFR 240.19b-4(f)(3).

<sup>10</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

pursuant to which Archipelago agreed to acquire PCXH and all of PCXH's wholly owned subsidiaries, including PCX and PCX's equities business subsidiary, PCX Equities, Inc. ("PCXE"), by way of a merger under Delaware law of the Merger Sub with and into PCXH, with PCXH as the surviving corporation (the "Merger").<sup>7</sup> The purpose of the proposed rule change is to amend the certificate of incorporation of PCXH ("Certificate of Incorporation of PCXH"), certain rules of the PCX, and the bylaws of Archipelago ("Archipelago Bylaws") to facilitate the consummation of the Merger.

#### A. Corporate Structure and Governance

PCXH, as the surviving corporation in the Merger, will become a direct, wholly owned subsidiary of Archipelago (the post-Merger PCXH is referred to herein as the "New PCXH"). The Certificate of Incorporation of PCXH as in effect immediately prior to the Effective Time will be amended pursuant to the Merger Agreement, as described in this proposed rule change, and as so amended will be the certificate of incorporation of the New PCXH. The bylaws of PCXH as in effect immediately prior to the Effective Time will be the bylaws of the New PCXH. The directors of the Merger Sub at the Effective Time will become directors of the New PCXH and the officers of PCXH at the Effective Time will become officers of the New PCXH.

As represented by PCX in the Notice, except as described in the Notice or otherwise approved by the Commission, the Merger will not affect the internal corporate structure of PCXH or the regulatory relationship of PCX and PCXE to Archipelago Exchange, L.L.C. ("ArcaEx"), the exclusive equities trading facility of PCX and PCXE. PCX will remain a wholly owned subsidiary of the New PCXH, will continue operating the options business of the Exchange, and will retain the self-regulatory organization responsibility for the options business and for PCX's equities business subsidiary, PCXE. ArcaEx will remain the exclusive equities trading facility of PCX and PCXE and the Amended and Restated Facility Services Agreement among Archipelago, PCX and PCXE, dated as of March 22, 2002, which currently governs the regulatory relationship of PCX and PCXE to ArcaEx (the "FSA"), will remain in full force and effect in its current form. Except as otherwise

discussed herein, PCXE's operations, governance structure, or rules will not be affected by the Merger. After the Merger, the board of directors of PCX and PCXE will continue to meet the compositional requirements set forth in the certificate of incorporation and bylaws of PCX and PCXE.

#### B. Self-Regulatory Function of PCX and Regulatory Jurisdiction Over Archipelago

Certain provisions of Archipelago's current certificate of incorporation ("Certificate of Incorporation of Archipelago") are designed to facilitate the ability of PCX, PCXE, and the Commission to fulfill their regulatory and oversight obligations under the Act.<sup>8</sup> All but one of these provisions remain applicable only for so long as ArcaEx remains a facility (as defined in Section 3(a)(2) of the Act)<sup>9</sup> of PCX and PCXE and the FSA remains in full force and effect. PCX represents that following completion of the Merger, ArcaEx will remain the exclusive equities trading facility of PCX and PCXE, and the FSA will remain in full force and effect in its current form. In order to assure, however, the continued force and effect of these provisions in the event of any change in the relationship of PCX and PCXE to ArcaEx or the effectiveness of the FSA after completion of the Merger, PCX proposes to amend the Archipelago Bylaws to provide that Archipelago will not take any action, and will not permit any of its subsidiaries (which will include PCXH, PCX, and PCXE, as well as ArcaEx) to take any action that will cause (i) ArcaEx to cease to be a facility of PCX and PCXE, or (ii) the FSA to cease to be in full force and effect, unless each provision in the Certificate of Incorporation of Archipelago that is subject to the limitation described above is amended to provide that such provision shall remain in full force and effect whether or not ArcaEx remains a facility of PCX and PCXE or the FSA is in full force and effect.<sup>10</sup>

<sup>8</sup> See Sections IV.A and IV.D of Securities Exchange Act Release No. 50170 (August 9, 2004), 69 FR 50419 (August 16, 2004) (order approving a proposed rule change in connection with the initial public offering of Archipelago) ("August 2004 Order"). These provisions include paragraphs (C)(3)(y), (D)(2), (D)(2)(a) and (H)(3) of Article Fourth, the third paragraph of Article EIGHTH, the penultimate paragraph of Article TENTH, and Articles THIRTEENTH, FOURTEENTH, FIFTEENTH, SIXTEENTH, SEVENTEENTH, EIGHTEENTH and NINETEENTH of the Certificate of Incorporation of Archipelago. See also Section 6.8(b) of the Archipelago Bylaws.

<sup>9</sup> 15 U.S.C. 78c(a)(2).

<sup>10</sup> Archipelago Bylaws, Proposed Section 6.8(c). The foregoing bylaw provision may not be amended, modified or repealed unless such

In addition, certain provisions of the current Certificate of Incorporation of Archipelago apply only to the extent that their requirements relate to ArcaEx.<sup>11</sup> Following completion of the Merger, PCX and PCXE will become wholly owned subsidiaries of Archipelago. To also apply these provisions to the operations of PCX and PCXE, PCX proposes to amend the Archipelago Bylaws to provide that:<sup>12</sup>

- Archipelago's books and records shall be subject at all times to inspection and copying by PCX and PCXE to the extent such books and records are related to the operation and administration of PCX or PCXE;<sup>13</sup>
- Archipelago shall take reasonable steps necessary to cause its agents to cooperate with PCX and PCXE pursuant to their regulatory authority with

amendment, modification or repeal is (i) filed with and approved by the Commission or (ii) approved by Archipelago stockholders voting not less than 80% of the then outstanding votes entitled to be cast in favor of any such amendment, modification or repeal. Archipelago Bylaws, Proposed Section 6.8(g). In addition, the Archipelago Bylaws will continue to provide that before any amendment to the bylaws shall be effective, such amendment shall be submitted to the Board of Directors of PCX and if such Board shall determine that the same is required, under Section 19 of the Act and the rules promulgated thereunder, to be filed with, or filed with and approved by, the Commission before such amendment may be effective under Section 19 of the Act and the rules promulgated thereunder, then such amendment shall not be effective until filed with, or filed with and approved by, the Commission, as the case may be. Archipelago Bylaws, Proposed Section 6.8(b).

PCX also proposes to amend Section 6.8(b) of the Archipelago Bylaws to eliminate the restriction that the provision applies only for so long as ArcaEx remains a facility of PCX and PCXE and the FSA is in full force and effect.

<sup>11</sup> Certificate of Incorporation of Archipelago, Article THIRTEENTH (relating to the submission by Archipelago and its officers, directors, and certain employees to the jurisdiction of the United States federal courts, the Commission, and PCX for matters arising out of or relating to the activities of ArcaEx); Article FOURTEENTH (providing for the inspection and copying by PCX and PCXE of Archipelago's books and records as they relate to the operation and administration of ArcaEx as a facility of PCX and PCXE); Article SEVENTEENTH (requiring Archipelago to take reasonable steps necessary to cause its agents to cooperate with PCX and PCXE with respect to such agents' activities related to ArcaEx); and Article EIGHTEENTH (requiring that Archipelago cause its officers, directors, and employees to consent to the applicability to them of certain provisions of the Certificate of Incorporation of Archipelago in connection with their activities related to ArcaEx).

<sup>12</sup> The following proposed bylaw provisions may not be amended, modified or repealed unless such amendment, modification or repeal is (i) filed with and approved by the Commission or (ii) approved by Archipelago stockholders voting not less than 80% of the then outstanding votes entitled to be cast in favor of any such amendment, modification or repeal. Archipelago Bylaws, Proposed Section 6.8(g).

<sup>13</sup> Archipelago Bylaws, Proposed Section 6.8(e)(i).

Merger Agreement (the agreement, as so amended, is referred to herein as the "Merger Agreement").

<sup>7</sup> The closing of the Merger is referred to herein as the "Effective Time" of the Merger.

respect to such agents' activities related to PCX or PCXE;<sup>14</sup>

- Archipelago shall take reasonable steps necessary to cause its officers, directors and employees prior to accepting a position as an officer, director or employee, as applicable, of Archipelago to consent in writing to the applicability to them of certain specified provisions of the Certificate of Incorporation of Archipelago with respect to their activities related to PCX or PCXE;<sup>15</sup> and

- Archipelago, its directors and officers, and those of its employees whose principal place of business and residence is outside the United States, shall be deemed to irrevocably submit to the exclusive jurisdiction of the United States Federal courts, the Commission and PCX for the purposes of any suit, action or proceeding pursuant to the United States Federal securities laws, and the rules and regulations thereunder, arising out of, or relating to, the activities of PCX or PCXE, and Archipelago and each such director, officer or employee, in the case of any such director, officer or employee by virtue of his acceptance of any such position, shall be deemed to waive, and agree not to assert by way of motion, as a defense or otherwise in any suit, action or proceeding, any claims that it or they are not personally subject to the jurisdiction of the Commission, that the suit, action or proceeding is an inconvenient forum or that the venue of the suit, action or proceeding is improper, or that the subject matter thereof may not be enforced in or by such courts or agency.<sup>16</sup>

In addition, Archipelago represents in the Notice that, prior to the earlier of (1) the 2006 annual general meeting of Archipelago stockholders and (2) the first meeting of Archipelago stockholders to occur after the closing of the Merger (other than any meeting or meetings of Archipelago stockholders convened for the purpose of considering

and approving the merger of Archipelago and the NYSE), that its board of directors will: (a) Propose amendments to the Certificate of Incorporation of Archipelago to (i) extend the application of voting and ownership limitations imposed on ETP Holders currently contained in the Certificate of Incorporation of Archipelago to OTP Holders and OTP Firms; (ii) delete the phrase "[f]or so long as ArcaEx remains a Facility of PCX and PCXE and the FSA remains in full force and effect" from each paragraph that contains such language;<sup>17</sup> and (iii) incorporate amendments to the provisions of the Certificate of Incorporation of Archipelago that are currently limited to activities of ArcaEx to cover activities of PCX and PCXE, as noted above;<sup>18</sup> (b) declare the advisability of such amendments; and (c) direct such amendments be submitted for stockholder approval at the earlier of (1) the 2006 annual meeting of Archipelago stockholders and (2) the first meeting of Archipelago stockholders to occur after the closing of the Merger (other than any meeting or meetings of Archipelago stockholders convened for the purpose of considering and approving the merger of Archipelago and the NYSE).<sup>19</sup>

### C. Change of Control of PCX; Voting and Ownership Limitations

The current Certificate of Incorporation of PCXH provides that (1) no person ("Person")<sup>20</sup> either alone or together with its related persons ("Related Persons"),<sup>21</sup> may own shares

<sup>17</sup> Paragraphs (C)(3)(y), (D)(2), (D)(2)(a) and (H)(3) of Article FOURTH, the third paragraph of Article EIGHTH, the penultimate paragraph of Article TENTH, Article THIRTEENTH, Article FOURTEENTH, Article FIFTEENTH, Article SIXTEENTH, Article SEVENTEENTH and Article NINETEENTH of the Certificate of Incorporation of Archipelago include this language.

<sup>18</sup> Articles THIRTEENTH, FOURTEENTH, SEVENTEENTH AND EIGHTEENTH of the Certificate of Incorporation of Archipelago would need to be so amended. See *supra* notes 13 to 16 and accompanying text.

<sup>19</sup> See Notice, *supra* note 3.

<sup>20</sup> Certificate of Incorporation of PCXH, Article Nine, Section 1(b)(iv), defines "person" as an individual, partnership (general or limited), joint stock company, corporation, limited liability company, trust or unincorporated organization, or any governmental entity or agency or political subdivision thereof.

<sup>21</sup> Certificate of Incorporation of PCXH, Article Nine, Section 1(b)(iv), defines "related person" to be (1) with respect to any person, all "affiliates" and "associates" of such person (as such terms are defined in Rule 12b-2 under the Act); (2) with respect to any person constituting a trading permit holder of PCX or an equities trading permit holder of PCXE, any broker dealer with which such holder is associated; and (3) any two or more persons that have any agreement, arrangement or understanding (whether or not in writing) to act together for the

constituting more than 40% of the outstanding shares of capital stock of PCXH,<sup>22</sup> and (2) no trading permit holder of PCX or equities trading permit holder of PCXE, either alone or together with its Related Persons, may own shares constituting more than 20% of the outstanding shares of capital stock of PCXH.<sup>23</sup> In addition, the Certificate of Incorporation of PCXH provides that no Person, either alone or together with its Related Persons, may vote, possess the right to vote or cause the voting of shares representing more than 20% of the issued and outstanding capital stock of PCXH, and also places limitations on the ability of any person, either alone or together with its Related Persons, to enter into an agreement with respect to the withholding of any vote or proxy.<sup>24</sup>

### 1. Exceptions to PCXH Ownership and Voting Restrictions

As a result of the Merger, Archipelago will own 100% of the capital stock of PCXH. Thus, absent an exception, Archipelago and its Related Persons, some of which are ETP Holders, would exceed these ownership and voting limitations in violation of the current Certificate of Incorporation of PCXH. The proposed rule change therefore would amend the Certificate of Incorporation of PCXH to create an exception to the voting and ownership limitations for Archipelago and certain Related Persons of Archipelago to permit Archipelago to own 100% of the capital stock of PCXH.<sup>25</sup>

In particular, the proposed rule change would add a new paragraph at the end of Article Nine of the Certificate of Incorporation of PCXH that would provide that, for so long as Archipelago directly owns all of the outstanding capital stock of PCXH, the provisions of Article Nine, including the ownership

purpose of acquiring, voting, holding or disposing of shares of the capital stock of PCXH.

<sup>22</sup> Certificate of Incorporation of PCXH, Article Nine, Section 1(b)(i). Such restriction may be waived by the board of directors of PCXH pursuant to an amendment to the Bylaws of PCXH adopted by the board after making certain findings and following certain procedures as described in more detail in the Notice, *supra* note 3, and in Securities Exchange Act Release No. 49718 (May 17, 2004), 69 FR 29611 (May 24, 2004) (the "May 2004 Order"). Certificate of Incorporation of PCXH, Article Nine, Sections 1(b)(i)(B) and 1(b)(i)(C).

<sup>23</sup> Certificate of Incorporation of PCXH, Article Nine, Section 1(b)(ii). There is no provision allowing the board to waive this restriction.

<sup>24</sup> Certificate of Incorporation of PCXH, Article Nine, Section 1(c). These restrictions were approved in connection with the 2004 demutualization of PCXH. See May 2004 Order, *supra* note 22, for a more detailed discussion of the current restrictions in the Certificate of Incorporation of PCXH.

<sup>25</sup> Certificate of Incorporation of PCXH, Proposed Article Nine, Section 4.

<sup>14</sup> Archipelago Bylaws, Proposed Section 6.8(e)(ii).

<sup>15</sup> Archipelago Bylaws, Proposed Section 6.8(e)(iii).

<sup>16</sup> Archipelago Bylaws, Proposed Section 6.8(e)(iv). Archipelago undertakes to take reasonable steps necessary to cause Archipelago's directors and officers and those Archipelago employees whose principal place of business and residence is outside the United States prior to accepting a position as an officer, director or employee, as applicable, of Archipelago to consent in writing to the applicability to them of this provision. Archipelago also undertakes that it will take reasonable steps necessary to cause Archipelago's current directors and officers and those current Archipelago employees whose principal place of business and residence is outside the United States to consent in writing prior to the consummation of the Merger to the applicability to them of this provision. See Notice, *supra* note 3.

and voting limitations with respect to shares of PCXH capital stock, would not be applicable to the voting and ownership of shares of PCXH capital stock by (1) Archipelago, (2) any person that is a Related Person of Archipelago, either alone or together with its related persons, and (3) any other person to which Archipelago is a Related Person, either alone or together with its Related Persons. These exceptions to the ownership and voting limitations, however, would not apply to "prohibited persons."<sup>26</sup>

"Prohibited persons" would be defined to mean any person that is, or that has a related person that is (1) an OTP Holder or an OTP Firm (as such terms are defined in the rules of PCX, as such rules may be in effect from time to time)<sup>27</sup> or (2) an ETP Holder (as such term is defined in the rules of PCX, as such rules may be in effect from time to time),<sup>28</sup> except: (A) any broker or dealer approved by the Commission after June 20, 2005 to be a facility (as defined in Section 3(a)(2) of the Act)<sup>29</sup> of PCX; (B) any person that has been approved by the Commission prior to it becoming subject to the provisions of Article Nine of the Certificate of Incorporation of PCXH with respect to the voting and ownership of shares of PCXH capital stock by such person; and (C) any person that is a related person of Archipelago solely by reason of beneficially owning, either alone or together with its Related Persons, less

<sup>26</sup> *Id.*

<sup>27</sup> PCX Rule 1.1(q) defines an "OTP Holder" to mean any natural person, in good standing, who has been issued an Options Trading Permit ("OTP") by the Exchange for effecting approved securities transactions on the Exchange's trading facilities, or has been named as a Nominee. PCX Rule 1.1(n) defines a "Nominee" to mean an individual who is authorized by an "OTP Firm" (a sole proprietorship, partnership, corporation, limited liability company or other organization in good standing who holds an OTP or upon whom an individual OTP Holder has conferred trading privileges on the Exchange's trading facilities) to conduct business on the Exchange's trading facilities and to represent such OTP Firm in all matters relating to the Exchange.

<sup>28</sup> PCXE Rule 1.1(n) defines an "ETP Holder" to mean any sole proprietorship, partnership, corporation, limited liability company or other organization in good standing that has been issued an Equity Trading Permit, a permit issued by the PCXE for effecting approved securities transactions on the trading facilities of PCXE.

<sup>29</sup> Section 3(a)(2) defines the term "facility," when used with respect to an exchange, to include its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service. 15 U.S.C. 78c(a)(2)

than 20% of the outstanding shares of Archipelago capital stock (any person covered by (A) through (C) is referred to as a "permitted person" in proposed Section 4 of Article Nine of the Certificate of Incorporation of PCXH).<sup>30</sup> The proposed Section 4 of Article Nine of the Certificate of Incorporation of PCXH would further provide that any other prohibited person not covered by the definition of a permitted person who would be subject to and exceed the voting and ownership limitations imposed by Article Nine as of the date of the closing of the Merger would be permitted to exceed the voting and ownership limitations imposed by Article Nine only to the extent and for the time period approved by the Commission.<sup>31</sup>

#### a. Outbound Router

Archipelago Securities is a registered broker-dealer, a member of the National Association of Securities Dealers, Inc. ("NASD"), and an ETP Holder. Archipelago Securities currently provides an optional routing service for ArcaEx to route orders to other securities exchanges, facilities of securities exchanges, automated trading systems, electronic communications networks or other brokers or dealers (collectively, "Market Centers") from ArcaEx in compliance with PCXE rules (such function of Archipelago Securities is referred to as the "Outbound Router"). In its capacity as an Outbound Router, Archipelago Securities operates and is regulated as a facility of PCX.<sup>32</sup> As such, the Outbound Router function of Archipelago Securities is subject to PCX's and the Commission's continuing oversight. In particular, PCX is responsible for filing with the Commission rule changes and fees relating to the Outbound Router function, and for ensuring that the Outbound Router complies with the requirement not to unfairly discriminate.<sup>33</sup> Archipelago intends to continue to own and operate Archipelago Securities following the closing of the Merger. The proposed operation of Archipelago Securities as

<sup>30</sup> Certificate of Incorporation of PCXH, Proposed Article Nine, Section 4.

<sup>31</sup> *Id.*

<sup>32</sup> Archipelago Securities was approved by the Commission to operate as a facility of PCXE on October 25, 2001 in connection with the Commission's approval of the rules of PCX establishing ArcaEx as a facility of PCXE. See Securities Exchange Act Release No. 44983 (October 25, 2001), 66 FR 55225 (November 1, 2001) (the "Original Outbound Router Release"). The name of the order routing broker-dealer was originally Wave Securities, L.L.C. as approved by the Commission in the Original Outbound Router Release.

<sup>33</sup> See, e.g., Section 6(b)(5) of the Act, 15 U.S.C. 78f(b)(5).

an Outbound Router after the closing of the Merger will not change from the way it is administered and operated today.<sup>34</sup>

After the closing of the Merger, Archipelago's continued ownership of Archipelago Securities would cause Archipelago Securities to exceed the ownership and voting limitations contained in Article Nine of the Certificate of Incorporation of PCXH (because Archipelago Securities is an ETP Holder and a Related Person of Archipelago), absent an exception. Pursuant to the proposed exception in proposed Article Nine, Section 4 of the Certificate of Incorporation of PCXH for a Related Person of Archipelago that is a broker or dealer approved by the Commission after June 20, 2005 to be a facility of PCX, PCX has proposed that the Commission approve Archipelago Securities, a wholly owned subsidiary of Archipelago, to be a facility (as defined in Section 3(a)(2) of the Act) of PCX, subject to the following:

- PCX will continue to regulate the Outbound Router function of Archipelago Securities as a facility of the Exchange, subject to Section 6 of the Act.

- The NASD, a self-regulatory organization ("SRO") unaffiliated with Archipelago or any of its affiliates, will continue to carry out oversight and enforcement responsibilities as the Designated Examining Authority ("DEA") designated by the Commission pursuant to Rule 17d-1 of the Act with the responsibility for examining Archipelago Securities for compliance with the applicable financial responsibility rules.

- The agreement between the NASD and PCX currently in place pursuant to Rule 17d-2 under the Act<sup>35</sup> (the "NASD PCX Agreement") will remain in full force and effect and PCX will continue to abide by the terms of such agreement. The NASD PCX Agreement allocates to

<sup>34</sup> As an Outbound Router, Archipelago Securities will continue to receive instructions from ArcaEx, route orders to other Market Centers in accordance with those instructions and be responsible for reporting resulting executions back to ArcaEx. In addition, all orders routed through Archipelago Securities would remain subject to the terms and conditions of PCXE rules. See Notice, *supra* note 3, and Original Outbound Router Release, *supra* note 32, at 55233-55235 (describing the operation of the order routing broker-dealer approved by the Commission).

<sup>35</sup> Rule 17d-2 provides that any two or more SROs may file with the Commission a plan for allocating among such SROs the responsibility to receive regulatory reports from persons who are members or participants of more than one of such SROs to examine such persons for compliance, or to enforce compliance by such persons, with specified provisions of the Act, the rules and regulations thereunder, and the rules of such SROs, or to carry out other specified regulatory functions with respect to such persons. 17 CFR 240.17d-2.

the NASD the responsibility to receive regulatory reports from Archipelago Securities, to examine Archipelago Securities for compliance and to enforce compliance by Archipelago Securities with the Act, the rules and regulations thereunder and the rules of the NASD, and to carry out other specified regulatory functions with respect to Archipelago Securities.

- PCX will amend the NASD PCX Agreement within 90 days of the Commission's approval of this proposed rule change<sup>36</sup> to expand the scope of the NASD's regulatory functions so as to encompass all of the regulatory oversight and enforcement responsibilities with respect to Archipelago Securities pursuant to applicable laws, except for real-time market surveillance.<sup>37</sup>

- An ETP Holder's use of Archipelago Securities to route orders to another Market Center from ArcaEx will continue to be optional. Any ETP Holder that does not want to use Archipelago Securities may use other routers to route orders to other Market Centers.<sup>38</sup>

- Archipelago Securities will not engage in any business other than its Outbound Router function (including, in that function, the self-clearing functions that it currently performs for trades with respect to orders routed to other Market Centers) and other activities approved by the Commission.

#### b. Inbound Router

As noted above in this Section II.C.1., the proposed rule change includes an exception to the ownership and voting restrictions in the Certificate of Incorporation of PCXH to allow any Related Person of Archipelago that is a prohibited person not covered by the definition of a permitted person to exceed these voting and ownership

limitations only to the extent and for the time period approved by the Commission.<sup>39</sup> Archipelago wholly owns and operates two other ETP Holders, Wave and Arca Trading.<sup>40</sup> Wave acts as an introducing broker for institutional customers to provide access to ArcaEx and other market centers.<sup>41</sup> Arca Trading acts as an introducing broker for non-ETP Holder broker-dealer customers for securities traded on ArcaEx (individually and collectively, the "Inbound Router functions").<sup>42</sup> In addition, Archipelago Securities provides clearing functions for trades executed by the Inbound Router function of Arca Trading.

As a wholly owned subsidiary of Archipelago, each of Wave and Arca Trading is a Related Person of Archipelago, and thus Archipelago's ownership of PCXH, absent an exception, would cause Wave and Arca Trading, as ETP Holders, to exceed the voting and ownership limitations imposed by Article Nine of the Certificate of Incorporation of PCXH. PCX requests the Commission's approval of a temporary exception for (1) Arca Trading and Archipelago Securities, with respect to the Inbound Router function of Arca Trading and the related clearing function of Archipelago Securities, and (2) for Wave to permit them to exceed the voting and ownership limitations imposed by Article Nine of the Certificate of Incorporation of PCXH (as proposed to be amended as described in this filing) to the following extent and for the following time periods:

- Archipelago may, until December 31, 2005, continue to own Wave provided Archipelago continues to maintain and comply with its current information barriers between Wave on the one hand and PCX, PCXE, and other subsidiaries of Archipelago that are facilities of PCX or PCXE on the other hand.<sup>43</sup>

- Archipelago may, until the earlier of March 31, 2006 and the closing date of the proposed merger of Archipelago and the NYSE, continue to own and operate the Inbound Router function of Arca Trading and the related clearing function of Archipelago Securities following the closing of its acquisition

<sup>39</sup> Certificate of Incorporation of PCXH, Proposed Article Nine, Section 4.

<sup>40</sup> Each of Wave and Arca Trading is a wholly owned subsidiary of Archipelago, an ETP Holder, and a member of the NASD. See Amendment No. 2.

<sup>41</sup> See Amendment No. 2.

<sup>42</sup> *Id.*

<sup>43</sup> PCX clarified in Amendment No. 2 that the request for a temporary exception for Wave is subject to this condition.

of PCXH provided that: (1) The revenues derived by Archipelago from the Inbound Router function of Arca Trading do not exceed 7% of the consolidated revenues of Archipelago (determined on a quarterly basis); (2) the Inbound Router function of Arca Trading does not accept any new clients following the closing of the Merger; and (3) Archipelago continues to maintain and comply with its current information barriers between the Inbound Router function of Arca Trading on the one hand and PCX, PCXE, and other subsidiaries of Archipelago that are facilities of PCX or PCXE on the other hand.<sup>44</sup>

#### c. Other ETP Holders That Are "Related Persons" of Archipelago

PCX requests the Commission's approval of a temporary exception for Terra Nova so that Terra Nova may be permitted to exceed the voting and ownership limitations imposed by Article Nine of the Certificate of Incorporation of PCXH (as proposed to be amended as described in this filing) to the following extent and for the following time periods:

- Gerald D. Putnam, Chairman and Chief Executive Officer ("CEO") of Archipelago, may, until December 31, 2005, continue to beneficially own in excess of 5% of Terra Nova and continue to serve as a director of TAL following the closing of the Merger notwithstanding the terms of the Certificate of Incorporation of PCXH, as proposed to be amended as described in this filing.<sup>45</sup>

Also, to abide by the terms of the Certificate of Incorporation of PCXH, as proposed to be amended as described in this filing, Kevin J.P. O'Hara, Chief Administrative Officer and General Counsel of Archipelago, and Paul Adcock, Managing Director, Trading, of

<sup>44</sup> See Amendment No. 2. The Commission also notes that each of Wave, Arca Trading and Arca Securities are covered by the NASD PCX Agreement, see Amendment No.2 and *supra* Section II.C.1.a, and that the NASD is the DEA for each.

<sup>45</sup> Terra Nova is an ETP Holder and a wholly owned subsidiary of TAL. Archipelago's ownership of PCXH would cause Terra Nova, as an ETP Holder, to exceed the ownership and voting limitations imposed by Article Nine of the Certificate of Incorporation of PCXH (as proposed to be amended) as of the date of the closing of the Merger, by virtue of Mr. Putnam's beneficial ownership in excess of 5% of Terra Nova and his service as a director of TAL. See Amendment No. 2. PCX clarified that Mr. Putnam's ownership of Terra Nova is beneficial, not direct. Terra Nova is a wholly owned subsidiary of TAL and Mr. Putnam owns 40% of TAL. Telephone conversation between Kathryn Beck, General Counsel, PCX and Jennifer Dodd, Special Counsel, Division of Market Regulation ("Division"), Commission, on September 20, 2005.

<sup>36</sup> See Amendment No. 2.

<sup>37</sup> In Amendment No. 2, PCX clarified that "real-time market surveillance" means marketplace regulation and marketplace surveillance, including surveillance and enforcement related to PCXE trading rules, PCX and PCXE rules relating to trading on ArcaEx, and Commission rules relating to trading.

<sup>38</sup> An ETP Holder may choose to route an order to ArcaEx that, if not executable on ArcaEx, will be cancelled and returned to the ETP Holder, at which time the ETP Holder could choose to route the order to another market.

Those ETP Holders who choose to use the Outbound Router function provided by Archipelago Securities must sign an Archipelago Securities Routing Agreement. Importantly, among other things, the Archipelago Securities Routing Agreement provides that all orders routed through Archipelago Securities are subject to the terms and conditions of PCXE rules. See Archipelago Securities Routing Agreement, <http://www.tradearca.com/exchange/pdfs/ETPApplication.pdf> (as of September 20, 2005).

Archipelago, shall resign from the board of directors of White Cap prior to the Effective Time.<sup>46</sup>

In addition to its Inbound Router services, Arca Trading operates an alternative trading system ("ATS"), as defined in Rule 300 of Regulation ATS under the Act,<sup>47</sup> for trading in over-the-counter bulletin board securities that are not traded on any securities exchange (the "ATS OTC function").<sup>48</sup>

Archipelago Securities also engages in the business of providing broker-dealer clients with direct connectivity to the NYSE, through the NYSE's Designated Order Turnaround system (the "DOT function").<sup>49</sup> PCX requests the Commission's approval of an exception for Arca Trading and Archipelago Securities from the voting and ownership limitations of Article Nine of the Certificate of Incorporation of PCXH (as proposed to be amended as described in this filing) to the following extent and for the following time periods:

- Archipelago may continue to own the ATS OTC function of Arca Trading for a period of 60 days following the closing of the Merger;<sup>50</sup> and
- Archipelago may own the DOT function of Archipelago Securities until the earlier of (1) a period of 60 days following the closing of the Merger, and (2) the closing date of the proposed merger of Archipelago and the NYSE.<sup>51</sup>

## 2. Ownership and Voting Restrictions on Archipelago Stockholders

The Certificate of Incorporation of Archipelago contains similar ownership and voting restrictions with respect to Archipelago stock as those imposed on PCXH stockholders under the Certificate of Incorporation of PCXH. These provisions are intended to ensure that the ownership of Archipelago by the public will not unduly interfere with or restrict the ability of the Commission or PCX to effectively carry out their regulatory oversight responsibilities under the Act, with respect to ArcaEx, and generally to enable ArcaEx to operate in a manner that complies with

the Federal securities laws, including furthering the objectives of Section 6(b)(5) of the Act.<sup>52</sup>

Specifically, (1) no person,<sup>53</sup> either alone or together with its related persons,<sup>54</sup> shall be permitted at any time to own beneficially shares of Archipelago stock representing in the aggregate more than 40% of the then outstanding votes entitled to be cast on any matter,<sup>55</sup> and (2) for long as ArcaEx is a facility of PCX and PCXE and the FSA is in effect,<sup>56</sup> no ETP Holder, either alone or with its related persons, shall be permitted at any time to own beneficially shares of Archipelago stock representing in the aggregate more than 20% of the then outstanding votes entitled to be cast on any matter.<sup>57</sup> In addition, no person, either alone or with its related persons, may (1) vote or cause the voting of shares of stock of Archipelago to the extent such shares represent in the aggregate more than 20% of the then outstanding votes

<sup>52</sup> These restrictions were approved by the Commission in connection with Archipelago's initial public offering in 2004. See August 2004 Order, *supra* note 8.

<sup>53</sup> Person means a natural person, company, government, or political subdivision, agency, or instrumentality of a government. Certificate of Incorporation of Archipelago, Article FOURTH, Section H(2).

<sup>54</sup> Related Persons is defined in Article FOURTH, Section H(3) of the Certificate of Incorporation of Archipelago.

<sup>55</sup> Such restriction may be waived by the board of directors of Archipelago after making certain findings and following certain procedures as described in more detail in Article FOURTH, Section D(1) of the Certificate of Incorporation of Archipelago.

<sup>56</sup> PCX proposes to amend the Archipelago Bylaws to provide that Archipelago will not take any action, and will not permit any of its subsidiaries to take any action that will cause (i) ArcaEx to cease to be a facility of PCX and PCXE, or (ii) the FSA to cease to be in full force and effect, unless each provision in the Certificate of Incorporation of Archipelago that is subject to this limitation, including this provision, is amended to provide that such provision shall remain in full force and effect whether or not ArcaEx remains a facility of PCX and PCXE or the FSA is in full force and effect. Archipelago also undertakes that its board of directors will propose, and declare the advisability of, and submit to shareholders certain amendments to its certificate to extend the ownership and voting limitations to all PCX members and to delete this limiting language. See *supra* notes 17 to 19 and accompanying text.

<sup>57</sup> Certificate of Incorporation of Archipelago, Section D(2) of Article FOURTH. The Certificate of Incorporation of Archipelago does not have any provisions that would permit the Board of Archipelago to waive the 20% limitation relating to any ETP Holders. In addition, if an ETP Holder, either alone or together with its related persons, owns beneficially shares of stock of Archipelago in excess of this 20% limitation, Archipelago would be required to call from such ETP Holder and its related persons that number of shares of stock entitled to vote that exceed the 20% limitation at a price equal to par value of the shares of stock. Certificate of Incorporation of Archipelago, Section D(2).

entitled to be cast on any matter ("Archipelago Certificate Voting Limitation"), or (2) enter into any agreement, plan or arrangement not to vote shares, the effect of which agreement, plan or arrangement would be to enable any person, either alone or with its related persons, to vote or cause the voting of shares that would represent in the aggregate more than 20% of the then outstanding votes entitled to be cast on any matter ("Archipelago Certificate Non-Voting Agreement Prohibition").<sup>58</sup>

Because Archipelago would own PCXH, and thus PCX, after the Merger, the proposed PCX rules would extend the ownership restriction in Archipelago's Certificate of Incorporation to PCX members other than ETP Holders. The proposed PCX rules would provide that for as long as Archipelago controls, directly or indirectly, PCX, no OTP Holder or OTP Firm, either alone or with its related persons,<sup>59</sup> shall own beneficially shares of Archipelago stock representing in the aggregate more than 20% of the then outstanding votes entitled to be cast on any matter (the "Ownership Limitation").<sup>60</sup>

In addition to this Ownership Limitation, the proposed PCX rules provide that for as long as Archipelago shall control, directly or indirectly, PCX, no OTP Holder or OTP Firm, either alone or together with its related persons, shall (1) have the right to vote, vote or cause the voting of shares of stock of Archipelago to the extent such shares represent in the aggregate more than 20% of the then outstanding votes entitled to be cast on any matter (the "Voting Limitation") or (2) enter into any agreement, plan or arrangement not to vote shares, the effect of which agreement, plan or arrangement would be to enable any person, either alone or with its related persons, to vote or cause the voting of shares that would represent in the aggregate more than 20% of the then outstanding votes entitled to be cast on any matter (the "Nonvoting Agreement Prohibition").<sup>61</sup>

<sup>58</sup> Certificate of Incorporation of Archipelago, Sections C of Article FOURTH.

<sup>59</sup> "Related persons" would be defined in proposed PCX Rule 1.1(gg).

<sup>60</sup> Proposed PCX Rule 3.4(a).

<sup>61</sup> Proposed PCX Rule 3.4(b). The Voting Limitation and Nonvoting Agreement Prohibition would not apply to (1) any solicitation of any revocable proxy from any stockholder of Archipelago by or on behalf of Archipelago or by an officer or director of Archipelago acting on behalf of Archipelago or (2) any solicitation of any revocable proxy from any stockholder of Archipelago by any other stockholder that is conducted pursuant to, and in accordance with, Regulation 14A promulgated pursuant to the Act. *Id.*

<sup>46</sup> White Cap is an ETP Holder and a Related Person of Archipelago by virtue of Messrs. O'Hara and Adcock's services as directors of White Cap. See Amendment No. 2.

<sup>47</sup> 17 CFR 242.300.

<sup>48</sup> See Amendment No. 2. Archipelago Securities provides clearing functions for trades executed on this ATS, and PCX requested an exception for this clearing function in the Notice.

<sup>49</sup> This service is separate from Archipelago Securities' Outbound Router function and is not included within the request for an exception for the Outbound Router function described in Section II.C.1.a. above. See Amendment No. 2.

<sup>50</sup> See Amendment No. 2.

<sup>51</sup> *Id.*

The proposed rules also would require OTP Holders, OTP Firms, and their "associated persons" (as such term is defined in Section 3(a)(18) of the Act,<sup>62</sup> and referred to as "OTP Associates"), to enter into an agreement with PCX and Archipelago<sup>63</sup> pursuant to which such OTP Holder, OTP Firm or OTP Associate would agree to comply with the ownership and voting limitations imposed by the proposed PCX rules,<sup>64</sup> to authorize Archipelago to vote their shares of Archipelago stock in favor of amendments to the Certificate of Incorporation of Archipelago that incorporate such ownership and voting limitations,<sup>65</sup> and to be subject to disciplinary action pursuant to the proposed PCX rules if they violate any of the ownership and voting limitations or fail to enter into such ownership and voting agreement (such agreement, the "Ownership and Voting Agreement").<sup>66</sup> Under the proposed rules, failure to comply with the ownership and voting limitations or failure to enter into the Ownership and Voting Agreement in a timely manner would subject the responsible OTP Holder or OTP Firm to the suspension of all trading rights and privileges, unless such violation is cured.<sup>67</sup>

<sup>62</sup> 15 U.S.C. 78c(a)(18).

<sup>63</sup> Proposed PCX Rule 3.4(c) would require (1) a person who is an OTP Holder, OTP Firm or OTP Associate which is not an ETP Holder and which (x) owns beneficially any shares of Archipelago stock or (y) has entered into any agreement, plan or other arrangement relating to the voting or ownership of any shares of Archipelago stock, at the time of the closing of the Merger, to enter into the Ownership and Voting Agreement (as defined below) no later than 30 calendar days following the date of closing of the Merger; and (2) a person who is any OTP Holder, OTP Firm or OTP Associate which is not required to enter into an Ownership and Voting Agreement pursuant to the above clause to enter into the Ownership and Voting Agreement no later than the fifth calendar day following the date on which: (x) such OTP Holder, OTP Firm or OTP Associate ceases being an ETP Holder and (A) owns or acquires beneficial ownership of any shares of Archipelago stock or (B) is a party to or enters into any agreement, plan or other arrangement relating to the voting or ownership of any shares of Archipelago stock; or (y) such OTP Holder, OTP Firm or OTP Associate which is not an ETP Holder (A) acquires beneficial ownership of any shares of Archipelago stock or (B) enters into any agreement, plan or other arrangement relating to the voting or ownership of any shares of Archipelago stock.

<sup>64</sup> Proposed PCX Rules 3.4(c)(1) and (c)(2).

<sup>65</sup> Proposed PCX Rule 3.4(c)(3).

<sup>66</sup> Proposed PCX Rule 3.4(d)(3).

<sup>67</sup> Proposed PCX Rule 13.2(a)(2)(E). Proposed PCX Rule 13.2(a)(2)(E) would provide that in the event of any such failure to comply with proposed PCX Rule 3.4, PCX shall: (1) provide notice to the applicable OTP Holder or OTP Firm within five business days of learning of the failure to comply; (2) allow the applicable OTP Holder, OTP Firm or OTP Associate of such OTP Holder or OTP Firm fifteen calendar days to cure any such failure to comply; (3) in the event that the applicable OTP Holder, OTP Firm or OTP Associate of such OTP Holder or OTP Firm does not cure such failure to

In addition, the proposed rules would require that the Ownership and Voting Agreement contain provisions designed to provide a disincentive for OTP Holders and OTP Firms to exceed the ownership and voting limitations imposed by the PCX rules. Specifically, proposed PCX Rule 3.4(d) would provide that in the event that any OTP Holder or OTP Firm, either alone or with its related persons (including any related persons who are OTP Associates of such OTP Holder or OTP Firm), at any time owns beneficially shares of Archipelago stock in excess of the Ownership Limitation, Archipelago would be required to promptly call from such OTP Holder or OTP Firm, or an OTP Associate of such OTP Holder or OTP Firm, at a price per share equal to the par value thereof, shares of Archipelago stock owned by such OTP Holder, OTP Firm or OTP Associate that are necessary to decrease the beneficial ownership of such OTP Holder or OTP Firm, either alone or with its related persons, to 20% of the then outstanding votes entitled to be cast on any matter after giving effect to the redemption of the shares of Archipelago stock.<sup>68</sup>

The proposed PCX rules and the Ownership and Voting Agreement also would provide that, if any OTP Holder or OTP Firm, either alone or with its related persons (including any related persons who are OTP Associates of such OTP Holder or OTP Firm), acquires the right to vote more than 20% of the then outstanding votes entitled to be cast by stockholders of Archipelago on any matter, Archipelago shall have the right to vote and shall vote such shares of Archipelago stock.<sup>69</sup> In addition, the proposed PCX rules and the Ownership and Voting Agreement would provide that in the event any OTP Holder or OTP Firm, either alone or with its related persons (including any related person that is an OTP Associate of such OTP Holder or OTP Firm), has cast votes, in person or by proxy or through any voting agreement or other arrangement, in excess of the Voting Limitation, Archipelago may bring suit in a court of competent jurisdiction against such OTP Holder, OTP Firm or

comply within such fifteen calendar day cure period, schedule a hearing to occur within thirty calendar days following the expiration of such fifteen calendar day cure period; and (4) render its decision as to the suspension of all trading rights and privileges of the applicable OTP Holder or OTP Firm no later than ten calendar days following the date of such hearing.

<sup>68</sup> Proposed PCX Rule 3.4(d)(1). For additional details on the procedures for making such calls and on the formula for determining the number of shares to be called, see Notice, *supra* note 3.

<sup>69</sup> Proposed PCX Rule 3.4(d)(2).

OTP Associates seeking enforcement of the Voting Limitation.<sup>70</sup>

Furthermore, the proposed PCX rules provide that in the event of any violation by any OTP Holder or OTP Firm of the Ownership Limitation, Voting Limitation or Nonvoting Agreement Prohibition (including, without limitation, any failure of an OTP Holder, OTP Firm or OTP Associate to enter into the Ownership and Voting Agreement within the applicable time periods), the Exchange shall suspend all trading rights and privileges of such OTP Holder or OTP Firm in accordance with proposed PCX Rule 13.2(a)(2)(E), subject to the procedures provided therein.<sup>71</sup>

In addition, PCX proposes an amendment to the Archipelago Bylaws that would prohibit the board of directors of Archipelago from waiving the 40% ownership limitation, the Archipelago Certificate Voting Limitation or the Archipelago Certificate Non-Voting Agreement Prohibition for any OTP Holder, OTP Firm, or any of their related persons.<sup>72</sup> The proposed amendments to the Archipelago Bylaws also would clarify that, should Archipelago call shares from certain of its stockholders in the event of breaches of certain ownership limitations pursuant to Archipelago's Certificate of Incorporation, the board of directors of Archipelago would cause Archipelago to call promptly shares of stock of Archipelago and also to give notice of such call promptly.<sup>73</sup>

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 2, including whether Amendment No. 2, 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](mailto:rule-comments@sec.gov). Please include File

<sup>70</sup> Proposed PCX Rule 3.4(d)(4). The Commission notes that OTP Holders and OTP Firms are currently subject to the existing voting limitations contained in the Certificate of Incorporation of Archipelago that apply to any person. Certificate of Incorporation of Archipelago, Article FOURTH, Section C.

<sup>71</sup> Proposed PCX Rule 3.4(d)(3).

<sup>72</sup> Archipelago Bylaws, Proposed Section 6.8(d). See Article FOURTH, Section H(3) of the Certificate of Incorporation of Archipelago for the definition of "related person." For additional details regarding this definition, see August 2004 Order, *supra* note 8.

<sup>73</sup> Archipelago Bylaws, Proposed Section 6.8(f).

Number SR-PCX-2005-90 on the subject line.

*Paper Comments:*

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, Station Place, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number SR-PCX-2005-90. 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 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 Amendment No. 2 of File Number SR-PCX-2005-90 and should be submitted on or before October 20, 2005.

#### IV. Discussion of Commission Findings

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>74</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(1) of the Act,<sup>75</sup> which requires a national securities exchange to be so organized and have the capacity to be able to carry out the purposes of the Act and to enforce compliance by its members and persons associated with its members with the provisions of the Act, the rules or regulations thereunder, and the rules of the exchange. The

<sup>74</sup> In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>75</sup> 15 U.S.C. 78f(b)(1).

Commission also finds that the proposal is consistent with Section 6(b)(5) of the Act,<sup>76</sup> which requires, among other things, that the rules of an exchange be designed to promote just and equitable principles of trade; to facilitate transactions in securities; to remove impediments to and perfect the mechanisms of a free and open market and a national market system; and, in general, to protect investors and the public interest.<sup>77</sup>

The Commission discusses below significant aspects of the proposed rule change.

#### *A. Self-Regulatory Function of the Exchange; Relationship Between PCX and Archipelago; Jurisdiction Over Archipelago*

As represented by PCX, the Merger will not affect the internal corporate structure of PCXH or the regulatory relationship among PCX, PCXE, and ArcaEx, except as described in Section II.A above or otherwise approved by the Commission. PCX will continue operating the options business of the Exchange, and ArcaEx will remain the exclusive equities trading facility of PCX and PCXE (and the FSA will remain in full force and effect in its current form). PCX will continue to operate as a registered national securities exchange under Section 6 of the Act, and will retain the self-regulatory organization function. Except as otherwise discussed herein, PCXE's operations, governance structure, or rules will not be affected by the Merger. All persons using PCX or ArcaEx will continue to be subject to the Exchange's rules and PCX will maintain its current regulatory authority over its members. Although Archipelago and PCXH do not themselves carry out regulatory functions, their activities with respect to the operation of ArcaEx and options trading on PCX should be consistent, and not interfere, with PCX's self-regulatory obligations.

Certain provisions in the Certificate of Incorporation and Bylaws of PCXH (as the owner of the Exchange) and Archipelago (as the owner and operator of the equities trading facility of the Exchange) are designed to maintain the independence of PCX's self-regulatory function and facilitate the ability of PCX, PCXE, and the Commission to

<sup>76</sup> 15 U.S.C. 78f(b)(5).

<sup>77</sup> The Commission notes that it is in the process of reviewing issues relating to new ownership structures of SROs, and has proposed rules relating to the ownership of SROs, including imposing restrictions on member ownership of an SRO or a facility of an SRO. See Securities Exchange Act Release No. 50699 (November 18, 2004), 69 FR 71126 (December 8, 2004).

fulfill their regulatory and oversight obligations under the Act.<sup>78</sup> For example, PCXH and Archipelago consented to the Commission's jurisdiction with respect to activities relating to PCX, or ArcaEx, respectively, agreed to provide the Commission and PCX access to their books and records to the extent they relate to PCX or ArcaEx, respectively, and agreed to cooperate with the Commission and PCX pursuant to their regulatory authority.<sup>79</sup> PCXH and Archipelago also agreed to keep confidential non-public information relating to PCX and not to use such information for any commercial purposes.<sup>80</sup> In addition, the boards of directors of PCXH and Archipelago are required to explicitly consider in the performance of their duties PCX's regulatory obligations under the Act.<sup>81</sup>

Because Archipelago will become the sole stockholder and the parent of PCXH as a result of the Merger, and thus the owner of the Exchange in addition to the equities trading facility of the Exchange, the Commission continues to believe that such provisions are appropriate. Certain of these provisions in the Certificate of Incorporation of Archipelago and the Archipelago Bylaws, however, currently apply only with respect to activities related to ArcaEx, or only so long as ArcaEx remains the exclusive equities trading facility of PCX and the FSA remains in full force and effect.<sup>82</sup> To assure the continued force and effect of these provisions after Archipelago acquires the Exchange, even if there is a change in the relationship of PCX and PCXE to ArcaEx or the effectiveness of the FSA after completion of the Merger, PCX proposes to amend the Archipelago Bylaws to expand the application of these provisions to activities related to PCX and PCXE.<sup>83</sup> In addition, PCX proposes to amend the Archipelago Bylaws to provide that Archipelago will not take any action, and will not permit any of its subsidiaries (which will include PCXH, PCX, and PCXE, as well

<sup>78</sup> See Sections V.C and V.D of the May 2004 Order, *supra* note 22, and Sections IV.A and IV.D of the August 2004 Order, *supra* note 8.

<sup>79</sup> Bylaws of PCXH, Article 7, Sections 7.03, 7.04 and 7.05 and Certificate of Incorporation of Archipelago, Articles THIRTEENTH, FOURTEENTH and SIXTEENTH.

<sup>80</sup> Bylaws of PCXH, Article 3, Section 3.15 and Certificate of Incorporation of Archipelago, Article FOURTEENTH.

<sup>81</sup> Bylaws of PCXH, Article 3, Section 3.15 and Certificate of Incorporation of Archipelago, Article TENTH.

<sup>82</sup> See *supra* notes 8 and 11 and accompanying text.

<sup>83</sup> See *supra* notes 12 to 16 and accompanying text.



as ArcaEx) to take any action that will cause (i) ArcaEx to cease to be a facility of PCX and PCXE, or (ii) the FSA to cease to be in full force and effect, unless each provision in the Certificate of Incorporation of Archipelago that is subject to the limitations described above is amended to provide that such provision shall remain in full force and effect whether or not ArcaEx remains a facility of PCX and PCXE or the FSA is in full force and effect.<sup>84</sup>

In addition, as noted above in Section II.B, Archipelago represents that, prior to the earlier of (1) the 2006 annual general meeting of Archipelago stockholders and (2) the first meeting of Archipelago stockholders to occur after the closing of the Merger (other than any meeting or meetings of Archipelago stockholders convened for the purpose of considering and approving the merger of Archipelago and the NYSE), that its board of directors will: (a) Propose amendments to the Certificate of Incorporation of Archipelago to (i) delete the phrase “[f]or so long as ArcaEx remains a Facility of PCX and PCXE and the FSA remains in full force and effect” from each paragraph that contains such language, and (ii) incorporate amendments to the provisions of the Certificate of Incorporation of Archipelago that are currently limited to activities of ArcaEx to cover activities of PCX and PCXE, as noted above;<sup>85</sup> (b) declare the advisability of such amendments; and (c) direct such amendments be submitted for stockholder approval at the earlier of (1) the 2006 annual meeting of Archipelago stockholders and (2) the first meeting of Archipelago stockholders to occur after the closing of the Merger (other than any meeting or meetings of Archipelago stockholders convened for the purpose of considering and approving the merger of Archipelago and the NYSE).<sup>86</sup>

These amendments to the Archipelago Bylaws, coupled with the undertakings of Archipelago, are designed to maintain the independence of PCX’s self-regulatory function and generally to enable the Exchange to operate in a manner that complies with the federal securities laws, including furthering the objectives of Sections 6(b) and 19(g) of the Act,<sup>87</sup> as well as to facilitate the ability of the Commission to exercise appropriate oversight over the Exchange and its controlling persons. The

Commission believes that these provisions are appropriate and consistent with the Act.

The Commission believes that, even in the absence of these proposed amendments and undertakings, Section 20(a) of the Act<sup>88</sup> provides that any person with a controlling interest in Archipelago would be jointly and severally liable with and to the same extent that Archipelago is liable under any provision of the Act, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action. In addition, Section 20(e) of the Act<sup>89</sup> creates aiding and abetting liability for any person who knowingly provides substantial assistance to another person in violation of any provision of the Act or rule thereunder, and Section 21C of the Act<sup>90</sup> authorizes the Commission to enter a cease-and-desist order against any person who has been “a cause of” a violation of any provision of the Act through an act or omission that the person knew or should have known would contribute to the violation.

#### *B. Change of Control of PCX; Ownership and Voting Limitations*

##### *1. Limited Exception To Allow Archipelago To Acquire PCXH*

As noted above, the Certificate of Incorporation of PCXH currently contains provisions that impose limitations on direct and indirect changes in control of PCXH that are designed to prevent any shareholder, or any shareholders acting together, from exercising undue control over the operations of the Exchange and to ensure that PCX, PCXE, and the Commission are able to carry out their regulatory obligations under the Act. These provisions include a separate, heightened ownership restriction on any member of PCX.<sup>91</sup> As a result of the Merger, Archipelago will own 100% of the capital stock of PCXH, which would violate the ownership and voting limitations in the current Certificate of Incorporation of PCXH, absent an exception.<sup>92</sup> Thus, to permit Archipelago to acquire PCXH, PCX has requested that the Commission approve a limited exception from the ownership and voting restrictions in PCXH’s Certificate of Incorporation for

Archipelago and its Related Persons, other than Related Persons that are “prohibited persons” (*i.e.*, PCX members) and that are not “permitted persons” or affirmatively approved by the Commission.<sup>93</sup>

Stockholders of Archipelago currently are subject to ownership and voting restrictions substantially similar to those imposed on PCXH stockholders.<sup>94</sup> The heightened restrictions on members of PCX, however, are not analogous, because the ownership restrictions contained in the Certificate of Incorporation of Archipelago that impose heightened restrictions on PCX members apply only to ETP Holders.<sup>95</sup> These heightened restrictions on ETP Holders were imposed at a time when Archipelago owned and operated ArcaEx, the equities trading facility of PCX, but not the options trading business of the Exchange. After the Merger, however, Archipelago will also own 100% of the Exchange. Therefore, to preserve the general applicability and scope of the ownership and voting restrictions as they currently exist in the Certificate of Incorporation of PCXH once Archipelago acquires PCXH, the Exchange requests that the Commission approve changes to PCX rules and the Archipelago Bylaws that are designed to impose substantially similar ownership and voting requirements on Archipelago’s stockholders that are PCX members to those that currently are imposed on PCXH stockholders that are PCX members.

Specifically, proposed PCX Rule 3.4 would impose on any OTP Holder or OTP Firm that is not an ETP Holder voting and ownership limitations that are analogous to those currently imposed on ETP Holders by the Certificate of Incorporation of Archipelago. The proposed PCX rules also would require OTP Holders, OTP Firms, and their OTP Associates to enter into Ownership and Voting Agreements with PCX and Archipelago pursuant to which such OTP Holder, OTP Firm or OTP Associate would agree to comply with the ownership and voting limitations imposed by the proposed PCX rules, to authorize Archipelago to vote their shares of Archipelago stock in favor of amendments to the Certificate of Incorporation of Archipelago that

<sup>93</sup> Certificate of Incorporation of PCXH, Proposed Article Nine, Section 4. See *supra* notes 27 to 31 and accompanying text for a detailed definition of “prohibited person” and “permitted person.”

<sup>94</sup> See *supra* notes 53 to 58 and accompanying text and Certificate of Incorporation of Archipelago, Article FOURTH, Sections C and D.

<sup>95</sup> See *supra* note 57 and accompanying text and Certificate of Incorporation of Archipelago, Article FOURTH, Section D(2).

<sup>84</sup> Archipelago Bylaws, Proposed Section 6.8(c). See *supra* notes 9 to 10 and accompanying text.

<sup>85</sup> Articles THIRTEENTH, FOURTEENTH, SEVENTEENTH AND EIGHTEENTH of the Certificate of Incorporation of Archipelago would need to be so amended.

<sup>86</sup> See Notice, *supra* note 3.

<sup>87</sup> 15 U.S.C. 78f(b) and 78s(g).

<sup>88</sup> 15 U.S.C. 78t(a).

<sup>89</sup> 15 U.S.C. 78t(e).

<sup>90</sup> 15 U.S.C. 78u-3.

<sup>91</sup> See *supra* notes 22 to 24 and accompanying text, and Section V.B of the May 2004 Order, *supra* note 22.

<sup>92</sup> Certificate of Incorporation of PCXH, Proposed Article Nine, Section 4.

incorporate such ownership and voting limitations, and to be subject to the disciplinary action in the proposed PCX rules if they violate any of the ownership and voting limitations or fail to enter into such Ownership and Voting Agreement.<sup>96</sup> Under the proposed rules, failure to comply with the ownership and voting limitations or failure to enter into the Ownership and Voting Agreement as required would subject the responsible OTP or OTP Firm to the suspension of all trading rights and privileges, unless such violation is cured within a limited time period.<sup>97</sup>

The Commission believes that the ownership and voting restrictions on OTP Holders and OTP Firms in the proposed PCX rules and the Ownership and Voting Agreement, along with the amendment to the Archipelago Bylaws that would prohibit the waiver of the 40% ownership limitations, Archipelago Certificate Voting Limitation and the Archipelago Certificate Non-Voting Agreement Prohibiting for OTP Holders, OTP Firms and their related persons, are reasonable and consistent with the Act. Members that trade on an exchange or through the facility of an exchange traditionally have ownership interests in such exchange or facility. As the Commission has noted in the past, however, a member's interest in an exchange could become so large as to cast doubt on

whether the exchange can fairly and objectively exercise its self-regulatory responsibilities with respect to that member. A member that is a controlling shareholder of an exchange might be tempted to exercise that controlling influence by directing the exchange to refrain from, or the exchange may hesitate to, diligently monitor and surveil the member's conduct or diligently enforce its rules and the federal securities laws with respect to conduct by the member that violates such provisions.

The proposed amendments to PCX rules and the Archipelago Bylaws that would extend ownership and voting limitations to non-ETP Holder members of PCX substantially similar to those that currently exist for ETP Holders, coupled with the existing ownership and voting limitations contained in the Certificate of Incorporation of Archipelago, are designed to preserve the current limitations on direct and indirect control of the Exchange, once Archipelago acquires PCXH. The Commission therefore believes it is appropriate and consistent with the Act to allow a limited exception from the PCXH ownership and voting limitations for Archipelago and certain of its Related Persons, to allow Archipelago to own 100% of PCXH. These proposed changes will help ensure that, upon consummation of the Merger, the public company nature of Archipelago will not unduly interfere with or restrict the regulatory oversight responsibilities of the Commission or PCX with respect to the options and equities business of the Exchange.

## 2. Exceptions for Members That Are Related Persons of Archipelago

Archipelago's 100% ownership of PCXH also would cause any member of PCX that is a Related Person of Archipelago (for instance, any member that is wholly owned by Archipelago) to exceed the ownership and voting limitations contained in the Certificate of Incorporation of PCXH. As noted above, the proposed exception from the ownership and voting restrictions contained in the Certificate of Incorporation of PCXH would apply to Archipelago and its Related Persons. The proposed exception would not, however, cover any Related Person that is a "prohibited person"—*i.e.*, an ETP Holder, OTP Holder, or OTP Firm—other than those members that are considered "permitted persons" or specifically approved by the Commission. Permitted persons would include: (A) Any broker or dealer approved by the Commission after June 20, 2005 to be a facility of PCX; (B) any

person which has been approved by the Commission prior to it becoming subject to the provisions of Article Nine of the Certificate of Incorporation of PCXH with respect to the voting and ownership of shares of PCXH capital stock by such person; and (C) any person which is a related person of Archipelago solely by reason of beneficially owning, either alone or together with its Related Persons, less than 20% of the outstanding shares of Archipelago capital stock.<sup>98</sup> The proposed Section 4 of Article Nine of the Certificate of Incorporation of PCXH would further provide that any other prohibited person not covered by the definition of a permitted person who would be subject to and exceed the voting and ownership limitations imposed by Article Nine as of the date of the closing of the Merger would be permitted to exceed the voting and ownership limitations imposed by Article Nine only to the extent and for the time period approved by the Commission.<sup>99</sup>

The Commission believes it is appropriate and consistent with the Act to exclude from the scope of the proposed exception to the PCXH ownership and voting limitations those Related Persons of Archipelago that are members of PCX, other than those that are specifically approved by the Commission or that are Related Persons solely because of their limited ownership of Archipelago stock, so as to help prevent a member or members of PCX from exercising undue influence over, or interfering with the operation and self-regulatory function, of the Exchange.

As detailed above, Archipelago currently owns or is affiliated with several member of PCX.<sup>100</sup> By virtue of their affiliation with Archipelago, these members would exceed the ownership and voting limitations in the Certificate of Incorporation of PCXH after Archipelago's acquisition of PCXH, absent an exception. These PCX members, however, would be excluded from the proposed exception to PCXH's ownership and voting limitations (and thus, Archipelago would be required to divest its interest in such PCX members) unless they are affirmatively approved by the Commission.

### a. Outbound Router

PCX has specifically requested that the Commission approve an exception for Archipelago Securities' Outbound

<sup>98</sup> Certificate of Incorporation of PCXH, Proposed Article Nine, Section 4.

<sup>99</sup> *Id.*

<sup>100</sup> See *supra* Section II.C.1.

<sup>96</sup> Proposed PCX Rule 3.4(c).

<sup>97</sup> See *supra* note 67 and proposed PCX Rule 13.2(a)(2)(E). PCX also proposes amendments to the Archipelago Bylaws that will prohibit the board of directors of Archipelago from waiving the 40% ownership limitation, the Archipelago Certificate Voting Limitation and the Archipelago Certificate Non-Voting Agreement Prohibition relating to any OTP Holder, OTP Firm, or any of their related persons. See *supra* note 72 and accompanying text. In addition, PCX proposes to amend the Archipelago Bylaws to provide that Archipelago will not take any action, and will not permit any of its subsidiaries to take any action that will cause (i) ArcaEx to cease to be a facility of PCX and PCXE, or (ii) the FSA to cease to be in full force and effect, unless each provision in the Certificate of Incorporation of Archipelago that is subject to this limitation, including the provision relating to ownership by ETP Holders, is amended to provide that such provision shall remain in full force and effect whether or not ArcaEx remains a facility of PCX and PCXE or the FSA is in full force and effect. Archipelago also undertakes that its board of directors would: (a) Propose amendments to the Certificate of Incorporation of Archipelago to (i) extend the application of voting and ownership limitations imposed on ETP Holders currently contained in the Certificate of Incorporation of Archipelago to OTP Holders and OTP Firms and (ii) delete the phrase "[f]or so long as ArcaEx remains a Facility of PCX and PCXE and the FSA remains in full force and effect" from each paragraph that contains such language; (b) declare the advisability of such amendments; and (c) direct such amendments be submitted for stockholder approval. See *supra* notes 10 and 17 to 19 and accompanying text.

Router function as a facility of the Exchange, pursuant to several conditions and undertakings. First, Archipelago Securities is, and will continue to be operated and regulated as, a facility of PCX. As a facility of PCX, PCX would be responsible for regulating the Outbound Router function as an exchange facility subject to Section 6 of the Act, and the Outbound Router function would be subject to the Commission's continuing oversight. Archipelago's performance of its Outbound Router function would have to be in compliance with PCX's rules.

Second, the scope of the exception would be limited to the Outbound Router function, *i.e.*, routing orders entered into ArcaEx to other Market Centers in compliance with PCXE rules. In addition, another unaffiliated SRO (the NASD) would continue to have primary regulatory oversight responsibility for Archipelago Securities pursuant to Rules 17d-1 and 17d-2 under the Act. The Commission emphasizes that PCX has undertaken to amend the NASD PCX Agreement<sup>101</sup> within 90 days of the Commission's approval of this proposed rule change to expand the scope of the NASD's regulatory functions under the NASD PCX Agreement so as to encompass all of the regulatory oversight and enforcement responsibilities with respect to Archipelago Securities pursuant to applicable laws, except for real-time market surveillance.<sup>102</sup> Finally, the continued use of the Outbound Router function also will remain optional for other PCX members.<sup>103</sup>

Although the Commission is concerned about potential unfair competition and conflicts of interest between an exchange's self-regulatory obligations and its commercial interests when the exchange is affiliated with one of its members, the Commission believes that it is appropriate and consistent with the Act to permit Archipelago to continue to own and operate Archipelago Securities, in its capacity as a facility of PCX that routes orders from ArcaEx to other Market Centers, in light of the protections

<sup>101</sup> The Commission notes that such amendment of the NASD PCX Agreement is required to be filed with the Commission pursuant to Rule 17d-2 under the Act.

<sup>102</sup> In Amendment No. 2, PCX clarified that real-time market surveillance means marketplace regulation and marketplace surveillance, including surveillance and enforcement related to PCXE trading rules, PCX and PCXE rules relating to trading on ArcaEx, and Commission rules relating to trading.

<sup>103</sup> See *supra* note 38 and accompanying text.

afforded by the conditions described above.

#### b. Inbound Router

PCX also has requested a temporary exception from the ownership and voting limitations for the Inbound Router functions of Wave until December 31, 2005, and for Arca Trading until the earlier of March 31, 2006 and the closing of Archipelago's pending merger with the NYSE.<sup>104</sup> These temporary exceptions would be subject to several conditions, as proposed. The operation of both Wave and Arca Trading's Inbound Router functions during the interim periods will continue to be subject to Archipelago's current information barriers between Wave and Arca Trading on the one hand and PCX, PCXE, and other subsidiaries of Archipelago that are facilities of PCX or PCXE on the other hand.<sup>105</sup> The Commission also notes that both Wave and Arca Trading are members of the NASD as well as PCX, that the NASD is the DEA for both Wave and Arca Trading, and that Wave and Arca Trading are, and will continue to be during the interim periods, covered by the scope of the NASD PCX Agreement.<sup>106</sup> In addition, during the interim period, the amount of revenue that Archipelago can earn from the operation of Arca Trading will not exceed 7% of its consolidated revenues, measured on a quarterly basis, and the Inbound Router function of Arca Trading will not accept any new clients following the closing of the Merger.

The affiliation of an exchange with one of its members that provides inbound access to the exchange—in direct competition with other members of the exchange—raises potential conflicts of interest between the exchange's regulatory responsibilities and its commercial interests, and the potential for unfair competitive advantage that the affiliated member could have by virtue of informational or operational advantages, or the ability to receive preferential treatment. In light of the conditions that would be imposed during the interim period that are designed to mitigate potential conflicts of interest and the potential for unfair competitive advantage, the Commission

<sup>104</sup> See *supra* notes 43 and 44 and accompanying text.

<sup>105</sup> See PCXE Rule 14.3.

<sup>106</sup> The Exchange confirmed that Wave and Arca Trading are, and will continue to be during the interim periods, covered by the scope of the NASD PCX Agreement. Telephone conversation between Kathryn Beck, General Counsel, PCX and David Hsu, Special Counsel, Division, Commission, on September 19, 2005.

believes it is appropriate and consistent with the Act to allow such a limited, temporary exception.<sup>107</sup>

#### c. Other PCX Members That Are Related Persons of Archipelago

As noted above in Section II.C.1.c., in addition to its Inbound Router function, Arca Trading provides the ATS OTC function,<sup>108</sup> and Archipelago Securities also provides the DOT function in addition to its Outbound Router function.<sup>109</sup> PCX requests the Commission's approval for an exception for Arca Trading to allow Archipelago to continue to own all of its ownership interest in and operate the ATS OTC function on a pilot basis for a period of 60 days following the Merger. PCX also requests an exception for Archipelago Securities to permit Archipelago to continue to own all of its ownership interest in and operate the DOT function of Archipelago Securities on a pilot basis until the earlier of (1) a period of 60 days following the closing of the Merger, and (2) the closing date of the proposed merger of Archipelago and the NYSE (provided that in no event will PCX or Archipelago request that this exception be extended beyond the closing date of the merger of Archipelago and the NYSE).<sup>110</sup> The Commission believes it is reasonable and consistent with the Act to approve these exceptions on a pilot basis, which will provide the public and other interested parties an opportunity to comment on the exceptions prior to any such exception being made permanent.

With respect to the ATS OTC function, the Commission notes that in its adoption of Regulation ATS, it stated that exchanges could form subsidiaries that operate ATSs registered as broker-dealers. The Commission noted that such subsidiaries would of course be required to become members of a national securities association or another national securities exchange. The Commission also stated that any subsidiary or affiliate ATS could not integrate, or otherwise link the ATS with the exchange, including using the premises or property of such exchange for effecting or reporting a transaction,

<sup>107</sup> The Commission believes that an Inbound Router function provided by an affiliated member of an exchange would be a facility of the exchange under Section 3(a)(2) of the Act, 15 U.S.C. 78c(a)(2), and would be regulated as such.

<sup>108</sup> See *supra* note 48 and accompanying text and Amendment No. 2.

<sup>109</sup> See *supra* note 49 and accompanying text and Amendment No. 2.

<sup>110</sup> See Amendment No. 2.

without being considered a facility of the exchange.<sup>111</sup>

Finally, PCX requests the Commission's approval for a temporary exception for Terra Nova until December 31, 2005 to allow Gerald D. Putnam (the Chairman and CEO of Archipelago) to continue to own in excess of 5% of Terra Nova and continue to serve as a director of TAL following the Merger.<sup>112</sup> The Commission believes that such a temporary exception is appropriate and consistent with the Act because it will eliminate the affiliation between Terra Nova and Archipelago but allow Mr. Putnam a reasonable amount of time to effectuate such actions necessary to eliminate the affiliation.

### C. Response to Comments

The Commission received one comment letter on the proposed rule change.<sup>113</sup> This commenter raises a concern regarding the level of change to the structure of the Exchange's options market that it believes Archipelago intends to undertake once the Merger has been completed, and the fact that Archipelago and PCX have not informed the Commission of their intent in connection with this proposed rule change. In particular, the commenter believes that the intended rule changes will align the PCX market with an existing "ECN-style" market structure of ArcaEx. The commenter recommends that the Commission not approve the pending merger while it investigates whether the intended rule changes will benefit the investing public.

Pursuant to Section 19(b)(2) of the Act,<sup>114</sup> the Commission is required to approve a proposed rule change on Form 19b-4 filed by an SRO pursuant to Rule 19b-4 under the Act<sup>115</sup> if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the SRO. PCX is not proposing to change its options market structure in this filing. The Commission has only considered whether the changes proposed by PCX in this rule filing are consistent with the Act. Similarly, the Commission would evaluate any future proposals by PCX to change its options rules pursuant to the statutory standards in Section 19(b)(2) of the Act.<sup>116</sup>

<sup>111</sup> See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) at 70891.

<sup>112</sup> See *supra* note 45 and accompanying text and Amendment No. 2.

<sup>113</sup> See *supra* note 4.

<sup>114</sup> 15 U.S.C. 78s(b)(2).

<sup>115</sup> 17 CFR 240.19b-4.

<sup>116</sup> 15 U.S.C. 78s(b)(2).

### V. Accelerated Approval of Amendment No. 2

Pursuant to Section 19(b)(2) of the Act,<sup>117</sup> the Commission may not approve any proposed rule change, or amendment thereto, prior to the thirtieth day after the date of publication of the notice thereof, unless the Commission find good cause for so finding. The Commission hereby find good cause for approving Amendment No. 2 to the proposed rule change prior to the thirtieth day after publishing notice of Amendment No. 2 in the **Federal Register** pursuant to Section 19(b)(2) of the Act.<sup>118</sup> Specifically, in Amendment No. 2, the Exchange: (1) Revised Form 19b-4 to reflect actions by the stockholders of PCXH approving the Merger on September 13, 2005; (2) made certain technical, non-substantive corrections to the text of the proposed rule change; (3) clarified the scope of the term "real-time market surveillance" in its discussion of the scope of the NASD PCX Agreement; (4) clarified the relationship between Archipelago and Wave, Archipelago and Terra Nova, Terra Nova and TAL, and Archipelago and White Cap in relation to its requests for temporary exceptions from the PCXH ownership and voting requirements; and (5) provided that the temporary exception it had requested for Wave in the Notice would be subject to a condition that Archipelago will continue to maintain and comply with its existing information barriers. These changes in items (1), (2), (3), and (4) are technical or non-substantive in nature, and the change in item (5) would provide additional safeguards for the proposed exception for Wave's Inbound Router function, and raise no new novel issues.

In Amendment No. 2, the Exchange also included a request for a temporary exception from the PCXH ownership and voting requirements for the Inbound Router function of Arca Trading and the related clearing function performed by Archipelago Securities, subject to certain conditions as outlined above in Section II.C.1.b. The Commission believes that good cause exists to accelerate approval of this exception because it is limited in duration (*i.e.*, Archipelago must divest its ownership interest or cease operations by March 31, 2006 at the latest) and subject to several conditions that are designed to mitigate any potential conflicts of interest between the ownership and operation by Archipelago of the Inbound Router function of Arca

<sup>117</sup> 15 U.S.C. 78s(b)(2).

<sup>118</sup> *Id.*

Trading and the self-regulatory function of PCX and the operation of ArcaEx, as well as any potential for unfair competitive advantage.

Finally, in Amendment No. 2 the Exchange requested (1) an exception on a 60 day pilot basis for Archipelago to be able to continue to own and operate an ATS for the trading of over-the-counter bulletin board securities not traded on any exchange and (2) an exception on a pilot basis until the earlier of (a) 60 days and (b) the closing of the pending merger between Archipelago and the NYSE for Archipelago to be able to continue to own and operate, through Archipelago Securities, a service that provides direct connectivity to the NYSE through the DOT system. The Commission believes that good cause exists to approve these two exceptions on a pilot basis because the public and other interested parties will have the opportunity to comment on the substance of the exceptions before permanent approval, if permanent approval is requested.

Therefore, the Commission finds that good cause exists to accelerate approval of Amendment No. 2 to the proposed rule change, pursuant to Section 19(b)(2) of the Act.<sup>119</sup>

### VI. Conclusion

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirement of the Act the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>120</sup> that: (1) The proposed rule change (SR-PCX-2005-90) and Amendment No. 1 thereto are approved; (2) Amendment No. 2 thereto is approved on an accelerated basis; (3) the exception for the ATS OTC Function of Arca Trading is approved on a pilot basis for a period of 60 days following the closing of the Merger; (4) the exception for the DOT Function of Archipelago Securities is approved on a pilot basis until the earlier of (i) a period of 60 days following the closing of the Merger, and (ii) the closing date of the proposed merger of Archipelago and the NYSE; (5) the temporary exception for Wave is approved until December 31, 2005; (6) the temporary exception for the Inbound Router function of Arca Trading and the related clearing function of Archipelago Securities is approved until the earlier of March 31, 2006 and the closing date of the proposed merger of Archipelago and the NYSE; and (7) the temporary exception

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

for Terra Nova is approved until December 31, 2005.

For the Commission, by the Division of Market Regulations, pursuant to delegated authority.<sup>121</sup>

**Jonathan G. Katz,**  
*Secretary.*

[FR Doc. E5-5314 Filed 9-28-05; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52495; File No. SR-Phlx-2005-14]

### Self-Regulatory Organizations; Philadelphia Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Amendment No. 1 Thereto Relating to Order Matching at the Opening in PACE

September 22, 2005.

#### I. Introduction

On March 10, 2005, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend Phlx Rule 229 to permit the PACE System<sup>3</sup> to modify the opening process to match certain orders, described below, to each other, where possible, instead of matching such orders with the specialist. On July 28, 2005, the Phlx filed Amendment No. 1 to the proposed rule change.<sup>4</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on August 17, 2005.<sup>5</sup> The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

#### II. Description of the Proposal

Currently, eligible market and limit orders received before the opening of the listing market<sup>6</sup> are guaranteed an execution against the specialist to whom

the order was directed (the "Directed Specialist")<sup>7</sup> at the open price. The Exchange has proposed to modify the PACE System to match certain eligible orders received before the open against other eligible contra-side orders (as available) at the opening price, rather than execute such orders against the Directed Specialist.<sup>8</sup> The Directed Specialist would continue to provide executions for any orders that would be ineligible for the proposed matching feature (as described below) and also for any imbalance of directed orders resulting from the proposed matching feature. However, the proposal would have the effect of removing the Directed Specialist from interaction with orders received before the open when such orders would be eligible for matching against other orders. The proposal also modifies the conditions for an order to be guaranteed an automatic execution at the listing market's opening price (whether matched against another order or against the Directed Specialist).

#### *Automatic Execution Guarantee*

Under the proposal, in order to be guaranteed an automatic execution at the listing market's opening price, market orders that are of a size equal to or smaller than the Directed Specialist's automatic execution guarantee size would need to be entered anytime before the actual opening of the applicable listing market, but market orders that are larger than the Directed Specialist's automatic execution guarantee size would need to be entered at least two minutes before the actual opening of the listing market.<sup>9</sup> Limit orders would need to be entered at least two minutes prior to the actual opening on the listing market and to be traded-through by the listing market's opening price in order to receive the automatic execution guarantee. Neither market orders nor limit orders would be eligible for an automatic execution guarantee at the listing market's opening price if they are marked sell short or laid-off by the Directed Specialist.

<sup>7</sup> The term "Directed Specialist" has the same meaning as in Phlx Rule 229A(b)(3), when there is more than one specialist assigned in a security. When there is only one specialist assigned in a security, the term Directed Specialist means that sole specialist.

<sup>8</sup> Under the proposal, the Exchange's matching algorithm would sort eligible orders by time priority and descending volume, thereby minimizing the number of different orders that any one order could match against.

<sup>9</sup> Under the proposal, a Directed Specialist could elect to adopt a shorter time threshold for the receipt of orders in all securities traded by the Directed Specialist.

#### *Orders Types Eligible for Matching*

Under the proposal, only round-lot market and limit orders would be eligible for matching at the opening price of the listing market. Other order types would not be eligible for the matching feature and would continue to be executed against the Directed Specialist, including: odd-lot orders, partial round-lot all-or-none orders, the odd-lot portion of partial round-lot eligible orders, and round-lot all-or-none orders when a single contra-side order with sufficient volume is not available. In addition, the imbalance of any directed orders that, although eligible for matching, could not match against other orders due to the lack of available contra-orders would be executed against the Directed Specialist.

#### *Other Changes*

Finally, the proposal would delete existing language in Phlx Rule 229, Supplementary Material .10(b), relating to the size of market and limit orders and the receipt time required to receive the opening price, since the treatment of such orders will be covered in Supplementary Materials .06 and .10(a), and it would also delete Supplementary Material .11 relating to the refusal of orders, as the Phlx believes that specialists today have sufficient methods available to them to manage the risk associated with orders received before the opening.

#### III. Discussion and Commission Findings

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>10</sup> In particular, the Commission believes that the proposal is consistent with Section 6(b)(5) of the Act,<sup>11</sup> which requires that the rules of an exchange be designed to promote just and equitable principles of trade, to 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 Commission notes that the proposal would remove all size restrictions on orders guaranteed an automatic execution at the opening price, provided that such orders are received within a certain time before the opening of the listing market and are not marked sell short or laid off at another

<sup>10</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>121</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> PACE is the Exchange's automated order routing, delivery, execution and reporting system for equities. See Phlx Rule 229.

<sup>4</sup> Amendment No. 1, which replaced and superseded the original filing in its entirety, included additional text in the purpose section to further clarify the description and operation of the proposed rule change, and also included a minor edit to the text of Phlx Rule 229.

<sup>5</sup> See Securities Exchange Act Release No. 52239 (August 11, 2005), 70 FR 48457 ("Notice").

<sup>6</sup> The term "listing market" refers to the applicable New York listing market.