SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51740; File No. SR-PCX-2005-64)

May 25, 2005

Self-Regulatory Organizations; Pacific Exchange, Inc.; Notice of Filing and Order Granting Accelerated Approval to a Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto Relating to the Market Maker Risk Limitation Mechanism

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on May 2, 2005, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On May 19, 2005, the PCX filed Amendment No. 1 to the proposed rule change.[3] On May 23, 2005 the PCX filed Amendment No. 2 to the proposed rule change.[4] On May 24, 2005 the PCX filed Amendment No. 3 to the proposed rule change.[5] On May 24, 2005 the PCX filed Amendment No. 4 to the proposed rule change.[6] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons. In addition, the Commission is granting accelerated approval of the proposed rule change, as amended.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 In Amendment No. 1, the PCX (a) added language to establish certain criteria regarding the use of the Market Maker Risk Limitation Mechanism and (b) added language to PCX Rule 6.37(g)(1), which governs quoting obligations of Lead Market Makers ("LMMs").

4 In Amendment No. 2, the PCX corrected certain typographical errors in the rule text and amended the proposed rule text of Rule 6.37(g)(1) to delete an incorrect reference to proposed PCX Rule 6.40(e).

5 In Amendment No. 3, the PCX corrected certain typographical errors in the rule text.

6 In Amendment No. 4, the PCX corrected certain typographical errors in Amendment No. 2.

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

The Exchange proposes to adopt PCX Rule 6.40 to provide PCX Market Makers protection from the unreasonable risk associated with an excessive number of near simultaneous executions in a single options class through the implementation of a Market Maker Risk Limitation Mechanism. The text of the proposed rule change, as amended, is below. Proposed new language is in italics; proposed deletions are in [brackets].

Rule 6

Market Maker Risk Limitation Mechanism

Rule 6.40 [Reserved.] (a) Trade Counter. The trading engine will maintain a "trade counter" for each Market Maker on each class to which the Market Maker is appointed. This trade counter will be incremented by one every time the Market Maker executes a trade on any series in the appointed class. The trade counter will automatically reset itself every “n” seconds.

(b) Market Maker Risk Limitation Mechanism. The trading engine will activate the Market Maker Risk Limitation Mechanism on an appointed class whenever the following conditions are met: The trade counter has reached “n” executions against the quotes of the Market Maker in the Market Maker’s appointed class during a period of “n” seconds. When the above conditions are met, the trading engine will automatically cancel all quotes posted by the Market Maker on that class by generating a “bulk cancel” message.

(c) The bulk cancel message will be processed in time priority with any other quote or order message received by the trading engine. Any orders or quotes that matched with the Market Maker’s quote and were received in the trading engine prior to the receipt of the bulk cancel message will be automatically executed. Orders or quotes received in the trading engine after receipt of the bulk cancel message will not be executed against the Market Maker.

(d) Once the Market Maker Risk Limitation Mechanism has been activated for an options class, any bulk quote messages sent by the Market Maker on that class would continue to be rejected until the Market Maker submits a message to the trading engine to enable new quotes.

(e) In the event that a Lead Market Maker's ("LMM") quotes are cancelled and there are no other Market Makers quoting in the issue, the trading engine will automatically provide two-sided legal quotes on behalf of the LMM until such time the LMM submits a message to the trading engine to enable new quotes. All quotes generated by the Exchange on behalf of an LMM will be considered "firm quotes" and shall be the obligation of the LMM.

(f) Each Market Maker that is quoting in an issue shall determine the appropriate trade counter threshold of "n" executions and the time period of "n" seconds as described in paragraph (b) above to activate the Market Maker Risk Limitation Mechanism. The trade counter threshold must be at least five executions. The time period must be at least ½ second. At no time may the trade counter be set for a trade rate of less than five executions in a one second period.

(g) For purposes of this Rule 6.40, a "bulk quote" message is a single message from a Market Maker that simultaneously updates all of the Market Maker's quotes in multiple series in a class at the same time.

Commentary:

.01 A trade rate of five executions in a one second period will allow for Market Makers to provide different risk settings. Based on a minimum rate of five executions per second, permissible settings could be five executions in a one second period, ten executions in a two

<u>second period fifteen executions in three a second period and so forth, using the same minimum executions per second ratio.</u>

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Obligations of Market Makers

Rule 6.37 (a)- (f) No change.

(g) Quoting Obligations of Market Makers.

(1) Lead Market Makers. Lead Market Makers must provide continuous two-sided quotations throughout the trading day in each of their appointed issues <u>for 99% of the time the Exchange is open for trading in each issue</u>. Such quotations must meet the legal quote width requirements of Rule 6.37(b). LMMs must also specify a size for each of their quotations applicable to:

(A) – (B) No change.

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II. <u>Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change</u>

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it had received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The PCX has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to provide all PCX Market Makers protection from the unreasonable risk of multiple nearly simultaneous executions. Like auto-quote systems used on other options exchanges, the primary method for Market Makers to update their markets on the PCX is to post and update quotes on multiple series of options at the same time through the use of "bulk quotes." Generally, these quotes are based on the Market Maker's proprietary pricing models that rely on various factors, including the price of the underlying security and that security's market volatility. As these variables change, a Market Maker's pricing model and automated quote system will continuously enter bulk quote updates for all series in the class.

A PCX Market Maker's risk is not limited to the risk in a single series of a particular class. Rather, a Market Maker faces exposure in all series of a class, requiring the Market Maker off set or otherwise hedge its overall position in a class. In addition to the Market Maker's own proprietary quoting system, the Market Maker Risk Limitation Mechanism would provide an additional tool to manage the risk associated with providing liquidity in a large number of series across an options class.

Because Market Makers provide quotes in all series in a class, they are exposed to the possibility of nearly simultaneous multiple executions that can create huge unintended principal positions for the Market Makers and expose them to unnecessary market risk. Firm risk management procedures dictate that Market Makers must take into account the possibility of such actions and the corresponding risk to the Market Makers and the firm. As a result, the PCX believes that Market Makers widen their quotes, quote less aggressively, and limit their quote size in order to avoid such unintended executions and the attendant risks and costs involved, all to the detriment of customers and other market participants. The proposed rule addresses these concerns.

Market Maker Risk Limitation Mechanism

The Market Maker Risk Limitation Mechanism feature on the PCX would protect all PCX Market Makers from excessive multiple and unintended automatic executions. The Market Maker Risk Limitation Mechanism would begin with a "trade counter" for each class where the Market Maker has a market making appointment. This trade counter would be incremented by one every time the Market Maker executes a trade on any series of the assigned class. The trade counter would reset itself every “n” seconds. The individual Market Maker supplying the quotes in a particular issue would define the threshold number for the trade counter to reach in order to trigger the implementation of the Market Maker Risk Limitation Mechanism. The individual Market Maker supplying the quotes in a particular issue would also define the time period for the trade counter to reset itself. The trade counter would have a minimum setting of five executions in a one second period. Using a trade rate of five executions in a one second period will allow for a Market Maker to provide different risk settings for different issue. This would limit the number of consecutive executions a given Market Maker could have automatically executed on an assigned class in a predefined period of time.

Once the trade counter has reached the defined threshold number, the trading engine would automatically cancel all quotes posted by that Market Maker on that class by generating a bulk cancel message. The bulk cancel message would have the same time priority as any other quote update or order message the trading engine receives, so that any orders or quotes that matched with the Market Maker’s quote and were received by the trading engine prior to the receipt of the cancel message would be automatically executed pursuant to PCX rules. Orders or quotes received by the trading engine after receipt of the cancel message would not be executed against the Market Maker.

As soon as the Market Maker Risk Limitation Mechanism is triggered, the Market Maker would receive a message to confirm the cancellation of the Market Maker's quotes on the given class. The Market Maker could then respond with an enabling message to the trading engine to update or refresh quotes. If there is no reply, PCX would assume there is a communication or system problem with the Market Maker.

In the event that a LMM is unable to provide an updated quote, and there are no other quotes in the PCX Plus system for that issue, the trading engine will create two sided, legal spread markets on behalf of the LMM. Quotes generated by the exchanges on behalf of the LMM would be considered firm quotes and would be the obligation of the LMM. When there are other quotes in the PCX system for that issue, the Exchange would not generate quotes on behalf of the LMM. Additionally, the Exchange proposes to amend PCX Rule 6.37(g)(1) to lower a LMM's continuous quotation obligation from 100% of the trading day to 99% of the trading day. This is designed to provide the LMM an appropriate amount of time to replenish quotes when the Exchange does not do this on the LMM's behalf. The Exchange anticipates that this new proposed functionality would be used in limited circumstances and only for brief periods of time.

The Market Maker Risk Limitation Mechanism would protect both Market Maker quotes currently posted and in the PCX Consolidated Book, as well as those incoming bulk quotes that a Market Maker may erroneously generate as part of an automatic update. For example, a new bulk quote message from a Market Maker that is immediately executable across multiple series would not generate a number of executions greater than the defined threshold number (i.e. would not allow the Market Maker to unintentionally sweep the book).

Without these protection mechanisms, multiple unintentional trades could automatically occur. These executions would not properly reflect the true nature of the market and would subject Market Makers to unreasonable market risk and multiple execution and clearing fees, with no real economic justification behind the trades. The Exchange believes the proposed rule change would reduce these inefficiencies and risks by preventing a PCX Market Maker from erroneously trading automatically multiple times. Under normal circumstances, PCX Market Maker quotes do match and are automatically executed; however, these are usually only on a few series in a class and involve immediate quote updates after an execution. The trade counter would not reach the threshold level, nor would the Risk Limitation Mechanism be activated under most circumstances.

The Exchange believes these protection mechanisms would eliminate trades that are involuntary, the result of technological error or inaccuracy, and that impede certain liquidity providers' ability to competitively quote. Also, the Exchange believes the protection mechanisms would increase the liquidity available in the PCX market and would enhance competition because Market Makers would be better able to quote large orders aggressively and with fewer concerns over technological breakdowns and system inaccuracies.

These Market Maker protections do not relieve a LMM or Market Maker’s obligations pursuant to PCX Rule 6.37(g), which addresses a Market Maker’s obligation to enter quotations for the option classes to which it is appointed, except as noted in proposed change to PCX Rule 6.37(g)(1). In addition, these Market Maker protections do not relieve a LMM or Market Maker’s obligations pursuant to Rule 6.86 to provide firm quotations. After a Market Maker protection has been utilized, all other Market Makers are expected to resume entering quotations for the options classes to which they are appointed as soon as practicable.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,[7] in general, and furthers the objectives of Section 6(b)(5) of the Act,[8] in particular, in that it is designed to facilitate transactions in securities, to promote just and equitable principles of trade, to enhance competition and to protect investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change, as amended, would impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments on the proposed rule change were neither solicited nor received.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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

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[7] 15 U.S.C. 78f(b).

[8] 15 U.S.C. 78f(b)(5).

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PCX-2005-64 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-PCX-2005-64. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the PCX. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-PCX-2005-64 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change

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.[9] In particular, the Commission believes that the proposed rule change is consistent with Section 6(b)(5) of the Act,[10] which requires among other things, that the rules of the Exchange are designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission notes that the proposal does not alter the obligations of PCX Market Makers, except for the fact that it will reduce a LMM's continuous quoting obligation from 100% of the trading day to 99% of the trading day for each of its appointed classes. The Commission notes that this reduction should provide the LMM a brief amount of time to update its quotes when the Exchange does not generate quotes on behalf of the LMM because no other market makers are quoting. In addition, the Commission believes that the proposed rule change should provide PCX Market Makers assistance in effectively managing their quotations.

The PCX has requested that the Commission find good cause for approving the proposed rule change and Amendment Nos. 1, 2, 3, and 4 thereto prior to the thirtieth day after publication of notice thereof in the Federal Register. The Commission notes that similar proposals to provide protection from risk for market makers have been approved for other options

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

10 15 U.S.C. 78f(b)(5).

exchanges.[11] The Commission believes that granting accelerated approval of the proposal should provide PCX Market Makers with similar protections from the risk associated with an excessive number of near simultaneous executions in a single options class. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2) of the Act,[12] for approving the proposed rule change, as amended, prior to the thirtieth day after the date of publication of notice thereof in the Federal Register.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[13] that the proposed rule change (SR-PCX-2005-64), and Amendment Nos. 1, 2, 3, and 4 thereto, are hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[14]

Margaret H. McFarland
Deputy Secretary

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11 See Securities Exchange Act Release Nos. 51049 (January 18, 2005), 70 FR 3756 (January 26, 2005) (SR-BSE-2004-52); and 51050 (January 18, 2005), 70 FR 3758 (January 26, 2005) (SR-ISE-2004-31).

12 15 U.S.C. 78s(b)(2).

13 15 U.S.C. 78s(b)(2).

14 17 CFR 200.30-3(a)(12).