

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

Nasdaq did not solicit or receive written comments on the proposed rule change.

III. 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2001-29 and should be submitted by May 29, 2001.

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

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.¹² In particular, the proposed rule change is consistent with the requirements of Section 15A(b)(6)¹³ of the Act in that it is designed to foster cooperation and coordination with persons engaged in processing information with respect to securities, 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.

In addition, the proposed rule change is consistent with Section 11A(a)(1)(C) of the Act,¹⁴ which provides that it is in

the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the availability to brokers, dealers, and investors of information with respect to quotations and transactions in securities. In adopting Rule 11Ac1-5, the Commission stated that the Rules would help further this and other national market system objectives.¹⁵ Many market centers may not have the necessary systems in place to collect and disseminate the statistical information required by the Rule. Moreover, developing such systems and allocating firm personnel necessary to produce internally the reports required by the rule may be a significant burden on some firms and may not be completed by the applicable compliance dates.¹⁶ The Commission anticipated that self-regulatory organizations might choose to provide services to assist their members in complying with the Rule.¹⁷ The ReSourceSM Service could enable many NASD member market centers to comply with Rule 11Ac1-5 in a more cost-effective and timely manner.

Pursuant to Section 19(b)(2),¹⁸ the Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice thereof in the **Federal Register**. Accelerated approval of the ReSourceSM Service will give subscribing firms an alternative means to comply with Rule 11Ac1-5 and allow sufficient time for market centers to develop and test their systems. Members must begin this process as soon as possible to ensure that they are prepared to comply with the Rule on August 1, 2001. Nasdaq states that many NASD members have inquired as to whether Nasdaq will offer such a service. Nasdaq believes that members may be hesitant to subscribe to the Service due to concern the ReSourceSM Service may not be approved or approved too late to enable members to comply with Rule 11Ac1-5. Moreover, a prospective subscriber of Nasdaq's ReSourceSM Service may be hesitant to commit resources to programming and testing systems for ReSourceSM if there is a possibility that approval will be delayed. Accelerated approval will

eliminate uncertainty regarding the ReSourceSM Service.

Accelerated approval of the ReSourceSM Service also will facilitate Nasdaq's ability to develop and test systems. Nasdaq represents that based on conversations with members, it has developed an estimate of the number of firms that are likely to subscribe and the resources required to provide the ReSourceSM Service. However, Nasdaq cannot confirm its estimates until it confirms the number of subscribers, which practically can be accomplished only when a subscriber pays for the ReSourceSM service. In addition, the cost of the ReSourceSM Service will be an important factor that potential subscribers will consider in determining whether to subscribe. Accelerated approval of the ReSourceSM service will enable Nasdaq to finalize their fee schedule sooner.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule change, SR-NASD-2001-29 is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁰

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-44233; File No. SR-PCX-00-25)

Self-Regulatory Organizations; Notice of Filing of Amendment No. 3 to Proposed Rule Change by the Pacific Exchange, Inc. Relating to the Archipelago Exchange

April 30, 2001.

Pursuant to Section 19(b)(1) under the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on April 19, 2001, the Pacific Exchange, Inc. ("PCX" or "Exchange"), through its subsidiary PCX Equities, Inc. ("PCXE" or "Corporation"), filed with the Securities and Exchange Commission ("Commission" or "SEC") Amendment No. 3 to the proposed rule change as described in Items I, II and III below, which Items have been prepared by the PCXE. On December 15, 2000, the proposed rule change and Amendment No. 1 was published for comment in the

¹⁵ See *supra* note 6.

¹⁶ The initial compliance date for the reporting of listed securities under Rule 11Ac1-5 was May 1, 2001. The Commission has temporarily exempted (until July 31, 2001) all orders in Nasdaq securities. Letter from Annette L. Nazareth, Director, Division of Market Regulation, SEC, to Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, dated April 12, 2001.

¹⁷ See *supra* note 6.

¹⁸ 15 U.S.C. 78s(b)(2).

¹² In approving this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹³ 15 U.S.C. 78o-3(b)(6).

¹⁴ 15 U.S.C. 78k-1(a)(1)(C).

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Federal Register.³ On February 27, 2001, the PCXE filed Amendment No. 2 to the proposal.⁴ The Commission is publishing this notice to solicit comments on Amendment No. 3 to the proposed rule change from interested persons. The Commission is also publishing the PCX's Supplemental Response to Comment Letters as Appendix A, B, and C.

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

The PCX, through its wholly owned subsidiary PCXE, is proposing to create a new electronic trading facility of the PCXE, called the Archipelago Exchange ("ArcaEx" or "Arca"). The proposed changes to the proposed rules, as published in the Arca Proposing Release, are below.

Additions are in *italics*; Deletions are in [brackets].

Rules of PCX Equities, Inc.

* * * * *

Rule 1

Definitions

Rule 1.1—No change.

(a)–(p)—No change.

Imbalance

(q) For the purposes of the Opening Auction, [and] the Market Order Auction and the Trading Halt Auction, as the case may be, the term "Imbalance" shall mean the number of buy or sell *shares* [orders] that can not be matched with other *shares* [orders] at the Indicative Match Price at any given time.

Indicative Match Price

(r) For the purposes of the Opening Auction, [or] the Market Order Auction and the Trading Halt Auction, as the case may be, the term "Indicative Match Price" shall mean for each security (1) the price at which the maximum volume of *shares* [orders] are executable; or (2) if there are two or more prices at which the maximum volume of *shares* [orders] are executable, the price that is closest to

the closing price of the previous trading day's normal market hours, as determined by the Consolidated Tape.

(s)–(w)—No change.

NASD

(x) The term "NASD" shall mean the National Association of Securities Dealers, Inc.

Nasdaq

(y) The term "Nasdaq" shall mean The Nasdaq Stock Market, Inc.

Nasdaq Market Maker

(z) The term "Nasdaq Market Maker" shall mean (1) a Nasdaq market maker as defined in NASD Rule 4200(a)(22), as amended from time to time, or (2) an electronic communications network ("ECN").

Nasdaq/NM Security

(aa) The term "Nasdaq/NM Security" shall mean any security (i) designated as a national market system security pursuant to the NASD's "National Market System Securities Designation Plan with respect to Nasdaq Securities," filed with and approved by the Commission pursuant to SEC Rule 11Aa2-1 under the Exchange Act and (ii) that is either listed on the Corporation pursuant to Rule 5 or as to which unlisted trading privileges have been granted pursuant to Section 12(f) of the Exchange Act.

Nasdaq System

(bb) The term "Nasdaq System" shall mean the system operated by Nasdaq.

Nasdaq System BBO

(cc) The term "Nasdaq System BBO" shall mean the best bid or offer that is disseminated pursuant to SEC Rule 11Ac1-1 among the Nasdaq System participants in those issues that are traded on the Nasdaq System.

(dd)–(gg) [(x)–(aa)]—No change.

OTC/UTP Participant

(hh) The term "OTC/UTP Participant" shall mean any registered national securities exchange or national securities association that is a signatory to the OTC/UTP Plan.

OTC/UTP Plan

(ii) The term "OTC/UTP Plan" shall mean the Nasdaq National Market/ Unlisted Trading System/ Unlisted Trading Privileges Plan, as from time to time amended according to its provisions.

OTC/UTP Primary Market

(jj) The term "OTC/UTP Primary Market" for a Nasdaq/NM Security means Nasdaq; provided, however, that

if for any 12-month period the number of reported transactions and the reported share volume in a Nasdaq/NM Security in any other OTC/UTP Participant's market exceeds 50% of the aggregate reported transactions and reported share volume of all OTC/UTP Participants in such security, then that OTC/UTP Participant's market shall be the OTC/UTP Primary Market.

OTC/UTP Regulatory Halt

(kk) The term "OTC/UTP Regulatory Halt" means a trade suspension or halt called by the OTC/UTP Primary Market for the purpose of dissemination of material news.

(ll)–(uu) [(bb)–(kk)]—No change.

Sponsorship Provisions

(vv) [(ll)] The term "Sponsorship Provisions" shall mean the provisions set [sent] forth in Rule 7.29(b)(2). For a Sponsored Participant to obtain authorized access to the Archipelago Exchange, the Sponsored Participant and its Sponsoring ETP Holder must enter into an agreement which incorporates the Sponsorship Provisions.

(ww)–(aaa) [(mm)–(qq)]—No change.

* * * * *

Rule 2

Equity Trading Permits

Rules 2.1–2.4—No change.

[Publication of Approved ETP Applications]

Rule 2.5. *Reserved.* [With respect to each ETP that is issued, the Corporation shall promptly distribute a notice thereof to all ETP Holders by publishing the name of each new ETP Holder in the Corporation's Weekly Bulletin.]

Rules 2.6–2.100—No change.

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Rule 7

Equities Trading

Rules 7.1–7.5—No change.

Trading Differentials

Rule 7.6(a)—No change.

Commentary:

.01–.04—No change.

.05 The minimum price variation ("MPV") for equity securities traded on the Archipelago Exchange shall be [1/64 of \$1.00 for those securities that are quoted in fractions and] \$0.01 [for those equity securities that are quoted in decimals]; provided, however, at all times the MPV shall be consistent with the Decimalization Implementation Plan.

.06 The minimum price improvement increment ("MPII") on the Archipelago

³ See Securities Exchange Act Release No. 43608 (Nov. 21, 2000), 65 FR 78822 (Dec. 15, 2000) ("Arca Proposing Release").

⁴ See letter from Cherie Macauley, Wilmer, Cutler & Pickering, Counsel for the Exchange to John Polise, Senior Special Counsel, Division of Market Regulation, Commission, dated February 26, 2001 ("Amendment No. 2"). The Commission does not believe that notice of Amendment No. 2 is necessary. Amendment No. 2 is similar to Amendment No. 3, but there are some substantive differences in Amendment No. 3 that supersede Amendment No. 2. Amendment No. 2 is publicly available in the Commission's Public Reference Room and the PCX's principal place of business.

Exchange shall be equal to \$0.01 or 10% of the NBBO spread, whichever is more.

(b)—No change.

Rules 7.7–7.17—No change.

Trading in Nasdaq/NM Securities

Rule 7.18[. Reserved.] (a) Access.

(1) *The Corporation shall permit each Nasdaq Market Maker, acting in its capacity as a market maker, telephone access, or such other access as may be established between the Corporation and the Nasdaq System (collectively, "approved access"), to the Corporation for each Nasdaq/NM Security in which such market maker is registered as a market maker. Such approved access shall include appropriate procedures to assure the timely response to communications received through telephone or other approved access.*

(2) *Nasdaq Market Makers may use such approved access to transmit orders for execution on the Corporation. Market Makers, via the facilities of the Corporation, may send orders via approved access to any Nasdaq Market Maker in each Nasdaq/NM security in which it displays quotations.*

(3) *Any order received via approved access from a Nasdaq Market Maker shall be effected in accordance with the Rules of the Corporation applicable to transactions on the Archipelago Exchange.*

(4) *No Market Maker shall permit the imposition of any access or execution fee, or any other fee or charge, with respect to transactions in Nasdaq/NM Securities effected with Nasdaq Market Makers that are communicated to the Corporation through telephone access.*

(b) *Display. The Corporation will display on the Archipelago Exchange, at a minimum, the Nasdaq System BBO.*

(c) *OTC/UTP Regulatory Halts. Whenever, in the exercise of its regulatory function, the OTC/UTP Primary Market for a Nasdaq/NM Security determines that an OTC/UTP Regulatory Halt is appropriate, the Corporation shall halt or suspend trading in that security until the notification by the OTC/UTP Primary Market that the halt or suspension is no longer in effect. The Corporation will assume that adequate publication or dissemination has occurred upon the expiration of one hour after initial publication in a national news dissemination service of the information that gave rise to an OTC/UTP Regulatory Halt and may, at its discretion, re-open trading at that time, notwithstanding notification from the OTC/UTP Primary Market that the halt or suspension is no longer in effect.*

(d) *Applicability. The following Rules of the Corporation will not be applicable*

to transactions on the Corporation in Nasdaq/NM Securities: Rules 7.16, 7.55–7.57.

Rules 7.19–7.22—No change.

Obligations of Market Makers

Rule 7.23(a). General. ETP Holders who are registered as Market Makers in one or more securities traded on the Corporation must engage in a course of dealings for their own account to assist in the maintenance, insofar as reasonably practicable, of fair and orderly markets on the Corporation in accordance with this Rule. The responsibilities and duties of a Market Maker specifically include, but are not limited to, the following:

(1)–(5)—No change.

(6) *[Enter and maintain a] Maintain one Cleanup Order in each security in which the Market Maker is registered as such for each Market Order Auction.*

(b)–(d)—No change.

Rules 7.24–7.30—No change.

Orders and Modifiers

Rule 7.31.

(a)–(e)—No change.

(f) Tracking Order.

(1)–(6)—No change.

(7) *The Corporation shall suspend the Tracking Order Process for a security when a locked or crossed market exists in that security. The Tracking Order Process for that security shall resume when the locked or crossed market in that security no longer exists.*

(8)–(7)—No change.

(g)–(h)—No change.

(i) Directed Order.

(1) *Any market or limit order to buy or sell which has been directed to a particular Market Maker by the User.*

(2) *The Corporation shall suspend the Directed Order Process for a security when a locked or crossed market exists in that security. The Directed Order Process for that security shall resume when the locked or crossed market in that security no longer exists.*

(j)–(r)—No change.

(s) *Cross Order. A two-sided order with instructions to match the identified buy-side with the identified sell-side at a specified price (the "cross price"). For the purposes of this Rule 7.31(s), an order of block size shall have the same meaning as set forth in Rule 7.57. A Cross Order will be executed as follows; provided, however, no Cross Orders shall be matched at the cross price without interacting with any orders in the Arca Book unless the cross price improves the BBO by the MPII:*

(1)—No change.

(2) *If the cross price is outside the NBBO,*

(A) *and the cross price is between the BBO,*

(i) *first, the portion of the Cross Order that may be executed in another market shall be routed away for execution [pursuant to Section 5 of Rule 7]; and*

(ii) *then, the remainder of the Cross Order shall be matched at the cross price without interacting with any orders in the Arca Book.*

(B) *and the cross price is at the BBO,*

(i) *first, the portion of the Cross Order that may be executed in another market shall be routed away for execution [pursuant to Section 5 of Rule 7];*

(ii)–(iii)—No change.

(C) *and the cross price is outside the BBO,*

(i) *and the NBBO is better than the BBO,*

(1) *first, the portion of the Cross Order that may be executed in another market shall be routed away for execution [pursuant to Section 5 of Rule 7];*

(2)–(3)—No change.

(t) *Auction-Only Limit Order. A limit order that is to be executed only during the Market Order Auction or the Trading Halt Auction, as the case may be.*

(u) *Cleanup Order.*

(1)(A) *[Only Market Makers may submit] Cleanup Orders may be submitted on behalf of Market Makers only [to the Archipelago Exchange]. Cleanup Orders may not be submitted on behalf of any Users other than Market Makers.*

(B) *Archipelago Exchange, on behalf of each Market Maker, will submit each Cleanup Order.*

(C) *Only one Cleanup Order per security may be submitted on behalf of each Market Maker.*

(2) *Cleanup Orders must be submitted [to the Archipelago Exchange] before 6:15 am (Pacific Time) and remain in effect until the conclusion of the Market Order Auction.*

(3)–(5)—No change.

(6) *Cleanup Orders will only be executed if:*

(A) *There is an Imbalance [of Market Orders] at the conclusion of the Market Order Auction, as provided in Rule 7.35; and*

(B) *The Imbalance is less than or equal to the aggregate size of all Cleanup Orders in the relevant security.*

(7)–(8)—No change.

(v)–(w)—No change.

(x) *Primary Only Order (PO Order). For exchange-listed securities only, a*

market order that is to be routed as a market-on-open order to the primary market for participation in the primary market opening or re-opening process.

(1) A PO Order entered for participation in the primary market opening must be entered before 6:28 am (Pacific Time) and it will not be included in the Market Order Auction.

(2) A PO Order entered for participation in the primary market re-opening after a trading halt must be entered after trading was halted on the Corporation and before the Re-Opening Time. The PO Order will not be included in the Trading Halt Auction.

Rules 7.32–7.33—No change.

Trading Sessions

Rule 7.34(a)—No change.

(b) Market Maker Obligations.

(1) [During the Core Trading Session,] Market Makers will be obligated to enter Q Orders in securities in which they are registered in accordance with Rule 7.23, beginning at the start of the Core Trading Session or at such earlier time during the Opening Session as determined from time to time by the Corporation, and continuing until the end of the Core Trading Session. [by the time Core Trading Hours begin. During the Opening Session and the Late Trading Session,] Market Makers are not obligated to enter Q Orders in securities in which they are registered at any times other than those established pursuant to the previous sentence.

(2) Market Makers [are required to enter at least] must maintain one Cleanup Order for all securities in which they are registered for each Market Order Auction.

(c)—No change.

(d) Orders Permitted in Each Session.

(1) During the Opening Session:

(A) Orders eligible for the Display Order Process [(other than Q Orders)] and for the Working Order Process that have been designated as available for the Opening Session are eligible for entry into and execution on the Archipelago Exchange.

(B)–(F)—No change.

(G) Notwithstanding that the Market Order Auction occurs during the Opening Session, as set forth in Rule 7.34(a)(1), the following orders not designated for the Opening Session shall participate in the Market Order Auction:

(i) Market orders designated for the Core Trading Session and entered prior to the conclusion of the Market Order Auction; and

(ii) Limited Price Orders designated for the Core Trading Session and entered prior to 6:28 am (Pacific Time).

(2)–(3)—No change.

(e)–(f)—No change.

Opening Session Auctions

Rule 7.35. (a) Order Entry and Cancellation Before Opening Auction

(1)—No change.

(2) Only Limited Priced Orders designated for the Opening Session will be eligible for the Opening Auction. Market orders entered before the Opening Auction or during the Opening Session will participate in the Market Order Auction. Limited Price Orders designated for the Core Trading Session and not designated for the Opening Session will become eligible for execution at the commencement of the Market Order Auction pursuant to Rule 7.35(c) [7.37 at the commencement of the Core Trading Session].

(3)–(4)—No change.

(b)—No change.

(c) Market Order Auction.

(1)—No change.

(2) Reduction of Imbalances

(A) Any Imbalance in the Market Order Auction may be reduced by new orders, entered on the side of the market opposite the Imbalance, pursuant to the following priority:

(i) Market orders;

(ii) Limited Price Orders eligible for the Opening Session;

(iii) Limited Price Orders designated for the Core Trading Session and entered before 6:28 am (Pacific Time);

(iv) Auction-Only Limit Orders; and

(v) Cleanup Orders.

(B) Between 6:28 am (Pacific Time) and the conclusion of the Market Order Auction, Limited Price Orders eligible for the Opening Session or the Core Trading Session may be cancelled, but Limited Price Orders not eligible for the Opening Session, market orders, Auction-Only Limit Orders and Cleanup Orders may not be cancelled.

(C)—No change.

(3) Determination of Market Order Auction Price

(A) If there is no Imbalance, orders will be executed in the Market Order Auction at the Indicative Match Price as of 6:30 am (Pacific Time).

(B) If an Imbalance exists, or if an equilibrium exists between buy market orders and sell market orders, as many buy market orders and sell market orders as possible shall be matched, on a time priority basis, once an NBBO is available,

(i) at the midpoint of the NBBO at 6:30 am (Pacific Time), in the case of exchange-listed securities for which the Corporation is not the primary market; or

(ii) at the midpoint of the NBBO at 6:30 am (Pacific Time), in the case of Nasdaq-listed securities, provided that the NBBO is not crossed; or

(iii) at the midpoint of the first uncrossed NBBO after 6:30 am (Pacific Time), in the case of Nasdaq securities in which the NBBO is crossed but one side of the BBO is not crossed by the NBBO; or

(iv) at the midpoint of the first uncrossed NBBO after 6:30 a.m. (Pacific Time), in the case of Nasdaq securities in which the NBBO is crossed and where both sides of the BBO are crossed by the NBBO; or

(i) [v] at the bid (offer) of the BBO that was crossed prior to 6:30 am (Pacific Time), in the case of Nasdaq securities in which the BBO is crossed by a market participant; or

(vi) at the Indicative Match Price as of 6:30 am (Pacific Time) in the case of those issues for which the Corporation is the primary market. If equilibrium exists between buy and sell market orders, the match price shall be at the last Corporation sale price in the security regardless of the trading session[, provided, that,]; however, if the last Corporation sale price is lower than [inferior to] the BBO, the match price shall be the displayed bid in the security, or if the last Corporation sale price is higher than the BBO, the match price will be the displayed offer in the security [Corporation bid (offer)].

Such executions shall be designated with a modifier to identify them as Market Order Auction trades. The market orders that are eligible for, but not executed in the Market Order Auction, shall become eligible for execution in the Core Trading Session immediately upon conclusion of the Market Order Auction.

(d) [Reserved.] Re-Opening After Trading Halts. To re-open trading in a security following a trading halt in that security, the Archipelago Exchange shall conduct a Trading Halt Auction, as described below:

(1) Re-Opening Time. After trading in a security has been halted, the Corporation shall disseminate the estimated time at which trading in that security will re-open (the “Re-Opening Time”).

(2) Publication of Indicative Match Price and Imbalances

(A) Immediately after trading is halted in a security, and various times thereafter as determined from time to time by the Corporation, the Indicative Match Price of the Trading Halt Auction and the volume available to trade at such price, shall be published via electronic means as determined from time to time by the Corporation. If such a price does not exist (i.e., there is an Imbalance of market orders), the Archipelago Exchange shall indicate via

electronic means that an Indicative Match Price does not exist.

(B) Immediately after trading is halted in a security, and various times thereafter as determined from time to time by the Corporation, the market order Imbalance associated with the Trading Halt Auction, if any, shall be published via electronic means as determined from time to time by the Corporation.

(C) If the difference between the Indicative Match Price and the last price prior to the trading halt, as determined by the Consolidated Tape, is equal to or greater than a pre-determined amount, as determined from time to time by the Corporation, the Archipelago Exchange will assign a "SIG" designator to such Indicative Match Price and publish such designator via electronic means as determined from time to time by the Corporation.

(3) Reduction of Imbalances

(A) Any Imbalance in the Trading Halt Auction may be reduced by new orders, entered on the side of the market opposite the Imbalance, pursuant to the following priority:

- (i) Market orders;
- (ii) Limited Price Orders; and
- (iii) Auction-Only Limit Orders.

(B) Primary Only Orders may be submitted to the Archipelago Exchange during a trading halt. Cleanup Orders are not eligible for execution in the Trading Halt Auction.

(C) The Corporation, if it deems such action necessary, will disseminate the time, prior to the time that orders are matched pursuant to the Trading Halt Auction, at which orders may no longer be cancelled.

(D) Interaction with ITS

(i) If a pre-opening indication is required pursuant to the ITS Plan, the Corporation will disseminate three minutes prior to the Re-Opening Time the applicable price range, consisting of the Indicative Match Price as one end of the price range and the Indicative Match Price plus an amount determined by the Corporation for the higher end of the price range.

(ii) The Archipelago Exchange will treat any responses to a pre-opening indication as an Auction-Only Limit Order.

(E) Other market centers may use private communication connections to enter Auction-Only Limit Orders for a Trading Halt Auction.

(4) Determination of Trading Halt Auction Price

(A) For exchange-listed stocks:

(i) If there is no Imbalance and no other market center has re-opened trading in the security, orders will be executed in the Trading Halt Auction at

the Indicative Match Price as of the Re-Opening Time.

(ii) If an Imbalance exists, or if an equilibrium exists between buy market orders and sell market order, or if another market center has re-opened trading in the security, as many buy market orders and sell market orders as possible shall be matched, on a time priority basis, at the midpoint of the first uncrossed, unlocked NBBO, once an NBBO is available.

(B) For Nasdaq stocks:

(i) If there is no Imbalance, orders will be executed in the Trading Halt Auction at the Indicative Match Price as of the Re-Opening Time.

(ii) If an Imbalance exists, or if an equilibrium exists between buy market orders and sell market orders, as many buy market orders and sell market orders as possible shall be matched, on a time priority basis, once an NBBO is available,

(a) at the midpoint of the NBBO at the Re-Opening Time, provided that the NBBO is not crossed; or

(b) at the midpoint of the first uncrossed NBBO after the Re-Opening Time, in the case in which the NBBO is crossed, but one side of the BBO is not crossed by the NBBO; or

(c) at the midpoint of the first uncrossed NBBO after the Re-Opening Time, in the case in which the NBBO is crossed and where both sides of the BBO are crossed by the NBBO; or

(d) at the bid (offer) of the BBO that was crossed prior to the Re-Opening Time, in the case in which the BBO is crossed by a market participant; or

(C) For those issues for which the Corporation is the primary market: Orders will be executed at the Indicative Match Price at the Re-Opening Time. If equilibrium exists between buy and sell market orders, the match price shall be at the last Corporation sale price in the security regardless of the trading session; however, if the last Corporation sale price is lower than the BBO, the match price shall be the displayed bid in the security, or if the last Corporation sale price is higher than the BBO, the match price will be the displayed offer in the security.

(5) If any orders are not executed in their entirety during the Trading Halt Auction, then such orders shall be executed in accordance with Rule 7.37 after the completion of the Trading Halt Auction.

(6) After the completion of the Trading Halt Auction, the Archipelago Exchange will re-open for trading the previously halted security in accordance with Rule 7.

(e)—No change.

(f) Whenever in the judgment of the Corporation the interests of a fair and orderly market so require, the Corporation may adjust the timing of the auctions set forth in this Rule.

Order Ranking and Display

Rule 7.36. The Archipelago Exchange shall display to Users and other market participants all non-marketable limit orders in the Display Order Process. The Archipelago Exchange will also disseminate current consolidated quotations/last sale information, and such other market information as may be made available from time to time pursuant to agreement between the Corporation and other market centers.

(a) Ranking. Orders of Users shall be ranked and maintained in the Display Order Process and/or Working Order Process of the Arca Book according to price-time priority, such that within each price level, all orders shall be organized by the time of entry in the following manner.

(1) Display Order Process. Within the Display Order Process:

(A)—No change.

(B) The displayed portion of Reserve Orders (not the reserve size) shall be ranked at the specified limit price and the time of order entry. If the displayed portion of the Reserve Order is decremented such that 99 shares or fewer are displayed [in its entirety], the displayed portion of the Reserve Order shall be refreshed for

(i) the displayed amount; or

(ii) the entire reserve amount, if the remaining reserve amount is smaller than the displayed amount,

from the reserve portion and shall be submitted and ranked at the specified limit price and the new time that the displayed portion of the order was refreshed.

(C)—No change.

(2)—No change.

(b)–(c)—No change.

Order Execution

Rule 7.37. Subject to the restrictions on short sales under Rule 10a–1 under the Exchange Act, like-priced orders, bids and offers shall be matched for execution by following Steps 1 through 5 in this Rule; provided, however, for an execution to occur in any Order Process, the price must be equal to or better than the NBBO, unless the Archipelago Exchange has routed orders to all away markets at the NBBO.

(a)—No change.

(b) If an incoming marketable order has not been executed in its entirety pursuant to paragraph (a) of this Rule, any remaining part of the order shall be routed to the Display Order Process.

(1) Step 2: Display Order Process.

(A) An incoming marketable order shall first attempt to be matched for execution against orders in the Display Order Process at the display price of the resident order for the total amount of stock available at that price or for the size of the incoming order, whichever is smaller. For the purposes of this subsection, the size of an incoming Reserve Order includes the displayed and reserve size and the size of the portion of the Reserve Order resident in the Display Order Process is equal to its displayed size. If the incoming marketable order has not been executed in its entirety, the remaining part of the order shall be routed to the Working Order Process.

(B)—No change.

(2) Step 3: Working Order Process.

(A)—(B)—No change.

(C) If any change in the NBBO or other available away trading interest would cause a potential match between the away order and an order in the Working Order Process, a commitment to trade shall be sent to that market center or market participant pursuant to Step 5 below *after having proceeded through Step 4*.

(c)—No change.

(d) Step 5: Routing Away.

(1)—No change.

(2) If an order has not been executed in its entirety pursuant to paragraphs (a) through (c) of this Rule and it has not been designated as a Fill-or-Return, Fill-or-Return Plus Order or PNP Order, the order shall be routed for execution as follows:

(A)(i) The order shall be routed, either in its entirety or as component orders, to another market center or market participant as a limit order priced at the quote published by the market center or market participant.

(ii) *Based upon a User's instruction, a marketable reserve order may be routed (1) serially as component orders, such that each component corresponds to the displayed size, or (2) only once in its entirety, including both the displayed and reserve portions.*

(B)—(E)—No change.

(e)—No change.

Rules 7.38–7.42—No change.

Use of Directed Order Process

Rule 7.43[.Reserved.] *It shall be considered conduct inconsistent with just and equitable principles of trade for a User to use the Directed Order Process for the purpose of bypassing otherwise applicable fees.*

Rules 7.44–7.64—No change.

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

In its filing with the Commission, the PCXE included statements concerning the purpose of, and basis for, the proposed rule change and discusses any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The PCXE 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

As discussed in detail in the Arca Proposing Release, the PCX proposes to establish rules for Arca, a new exchange facility, as that term is defined in Section 3(a) of the Exchange Act.⁵ Arca, which is operated by Archipelago Exchange, L.L.C., is an electronic securities communications and trading facility intended for the use of ETP Holders and their customers. Arca would provide automatic order execution capabilities in the equity securities listed or traded on the PCXE. Arca would operate in place of PCXE's traditional floor trading facilities. In addition to certain minor changes, like renumbering rules,⁶ the PCXE proposes the following substantive changes to the proposed rule changes set forth in the Arca Proposing Release.⁷

a. Implementation of OTC/UTP Plan

To implement the OTC/UTP Plan, the PCX proposes the addition of Proposed Rule 7.18—"Trading in Nasdaq/NM Securities"—as well as a number of new definitions in Proposed Rule 1. These rule revisions are described below.

⁵ 15 U.S.C. 78c(a).

⁶ In addition to the proposed rule changes, the PCX proposes several corrections to the text of the Arca Proposing Release:

(1) *Section 2(c)(iv) (Order Execution)*, footnote 82—Footnote 82 should read "'Marketable' means, for a Limited Price Order, the price crosses or matches the NBBO on the other side of the market. Market orders are always considered marketable." See Arca Proposing Release at 78827.

(2) *Section 2(c)(vii) (Opening Session Auctions)*—In the second paragraph under "Opening Auctions," the references to "the last .T sale" should be replaced with the phrase "the prior day's closing price." See Arca Proposing Release at 78832.

(3) *Section 2(c)(vii) (Opening Session Auctions)*—Example 3 of the Market Order Auction should be deleted. See Arca Proposing Release at 78833.

⁷ See Arca Proposing Release, note 3, *supra*.

i. Definitions

The PCX introduces the following new terms in Proposed Rule 1:

(1) *Proposed Rule 1.1(x)*—PCXE has inserted as Proposed Rule 1.1(x) the following definition of the term "NASD" shall mean "the National Association of Securities Dealers, Inc."

(2) *Proposed Rule 1.1(y)*—PCXE has added the definition of the term "Nasdaq" as Proposed Rule 1.1(y). "Nasdaq" means "The Nasdaq Stock Market, Inc."

(3) *Proposed Rule 1.1(z)*—PCXE has added the definition of the term "Nasdaq Market Maker" as Proposed Rule 1.1(z). A "Nasdaq Market Maker" shall mean (1) a Nasdaq market maker as defined in NASD Rule 4200(a)(22), as amended from time to time, or (2) an electronic communications network ("ECN").

(4) *Proposed Rule 1.1(aa)*—PCXE has added as Proposed Rule 1.1(aa) the definition of the term "Nasdaq/NM Security," which means "any security (i) designated as a national market system security pursuant to the NASD's 'National Market System Securities Designation Plan with respect to Nasdaq Securities,' filed with and approved by the Commission pursuant to SEC Rule 11Aa2-1 under the Exchange Act and (ii) that is either listed on the Corporation pursuant to Rule 5 or as to which unlisted trading privileges have been granted pursuant to Section 12(f) of the Exchange Act."

(5) *Proposed Rule 1.1(bb)*—PCXE has inserted the definition of the term "Nasdaq System" as Proposed Rule 1.1(bb). "Nasdaq System" means "the system operated by Nasdaq."

(6) *Proposed Rule 1.1(cc)*—PCXE has added the definition of the term "Nasdaq System BBO" as Proposed Rule 1.1(cc). "Nasdaq System BBO" means "the best bid or offer that is disseminated pursuant to SEC Rule 11Ac1-1 among the Nasdaq System participants in those issues that are traded on the Nasdaq System."

(7) *Proposed Rule 1.1(hh)*—PCXE has added the definition of the term "OTC/UTP Participant" as Rule 1.1(hh). "OTC/UTP Participant" is defined as "any registered national securities exchange or national securities association that is a signatory to the OTC/UTP Plan."

(8) *Proposed Rule 1.1(ii)*—PCXE has inserted the definition of the term "OTC/UTP Plan as Proposed Rule 1.1(ii). "OTC/UTP Plan" shall mean "the Nasdaq National Market/Unlisted Trading System/Unlisted Trading Privileges Plan, as from time to time amended according to its provisions."

(9) *Proposed Rule 1.1(jj)*—PCXE has inserted the definition of the term “OTC/UTP Primary Market” as Proposed Rule 1.1(jj). “OTC/UTP Primary Market” for a Nasdaq/NM Security “means Nasdaq; provided, however, that if for any 12-month period the number of reported transactions and the reported share volume in a Nasdaq/NM Security in any other OTC/UTP Participant’s market exceeds 50% of the aggregate reported transactions and reported share volume of all OTC/UTP Participants in such security, then that OTC/UTP Participant’s market shall be the OTC/UTP Primary Market.”

(10) *Proposed Rule 1.1(kk)*—PCXE has inserted the definition of “OTC/UTP Regulatory Halt” as Proposed Rule 1.1(kk). An “OTC/UTP Regulatory Halt” is “a trade suspension or halt called by the OTC/UTP Primary Market for the purpose of dissemination of material news.”

ii. Trading in Nasdaq/NM Securities

To implement the OTC/UTP Plan for the PCXE, PCXE has added Proposed Rule 7.18, “Trading in Nasdaq/NM Securities,” which is described in more detail below.

Paragraph (a) of Proposed Rule 7.18 describes access for trading Nasdaq/NM Securities. Paragraph (a)(1) reads: “The Corporation shall permit each Nasdaq Market Maker, acting in its capacity as a market maker, telephone access, or such other access as may be established between the Corporation and the Nasdaq System (collectively, “approved access”), to the Corporation for each Nasdaq/NM Security in which such market maker is registered as a market maker. Such approved access shall include appropriate procedures to assure the timely response to communications received through telephone or other approved access.” Paragraph (a)(2) states that “Nasdaq Market Makers may use such approved access to transmit orders for execution on the Corporation. Market Makers, via the facilities of the Corporation, may send orders via approved access to any Nasdaq Market Maker in each Nasdaq/NM security in which it displays quotations.” Paragraph (a)(3) provides that “[a]ny order received via approved access from a Nasdaq Market Maker shall be effected in accordance with the Rules of the Corporation applicable to transactions on the Archipelago Exchange.” Paragraph (a)(4) reads: “No Market Maker shall permit the imposition of any access or execution fee, or any other fee or charge, with respect to transactions in Nasdaq/NM Securities effected with Nasdaq Market

Makers that are communicated to the Corporation through telephone access.”

Paragraph (b) of Proposed Rule 7.18 states that “[t]he Corporation will display on the Archipelago Exchange, at a minimum, the Nasdaq System BBO.”

Paragraph (c), which describes OTC/UTP Regulatory Halts states:

“Whenever, in the exercise of its regulatory function, the OTC/UTP Primary Market for a Nasdaq/NM Security determines that an OTC/UTP Regulatory Halt is appropriate, the Corporation shall halt or suspend trading in that security until the notification by the OTC/UTP Primary Market that the halt or suspension is no longer in effect. The Corporation will assume that adequate publication or dissemination has occurred upon the expiration of one hour after initial publication in a national news dissemination service of the information that gave rise to an OTC/UTP Regulatory Halt and may, at its discretion, re-open trading at that time, notwithstanding notification from the OTC/UTP Primary Market that the halt or suspension is no longer in effect.”

Finally, paragraph (d) states that “[t]he following Rules of the Corporation will not be applicable to transactions on the Corporation in Nasdaq/NM Securities: Rules 7.16, 7.55–7.57.”

b. Re-Opening After Trading Halts

The PCX has introduced a procedure, called the Trading Halt Auction, for re-opening a security after a trading halt. The Trading Halt Auction is described in detail in Proposed Rule 7.35(d). Moreover, the definitions of certain auction-related terms have been revised to reflect this new procedure.

i. Definitions

The following definitions have been revised to accommodate the Trading Halt Auction:

(1) *Proposed Rules 1.1(q) and (r)*—The definitions of “Imbalance” and “Indicative Match Price” have been revised to indicate that these terms are applicable to the Trading Halt Auction as well as the Opening and Market Order Auctions.

(2) *Proposed Rule 7.31(t)*—The definition of an Auction-Only Limit Order has been revised to state that it is a limit order that is to be executed during the Trading Halt Auction or the Market Order Auction.

(3) *Proposed Rule 7.31(x)*—The definition of a Primary Only Order (“PO Order”) has been revised to clarify that a User may submit a PO Order for participation in the primary market re-opening process as well as the primary

market opening process. Proposed Rule 7.31(x)(2) states that “[a] PO Order entered for participation in the primary market re-opening after a trading halt must be entered after trading was halted on the Corporation and before the Re-Opening Time. The PO Order will not be included in the Trading Halt Auction.”

ii. Trading Halt Auction

Subject to certain minor variations, the Trading Halt Auction, as described in Proposed Rule 7.35, operates in much the same fashion as the Market Order Auction. Specifically, to re-open trading in a security following a trading halt in that security, Arca will conduct a Trading Halt Auction, as described below.

After trading in a security has been halted, the PCXE will disseminate the estimated time at which trading in that security will re-open. This estimated time will be designated the “Re-Opening Time.” Similarly, immediately after trading is halted in a security, and various times thereafter as determined from time to time by the PCXE, the Indicative Match Price of the Trading Halt Auction and the volume available to trade at such price, shall be published via electronic means as determined from time to time by the PCXE. If such a price does not exist (*i.e.*, there is an Imbalance of market orders), Arca shall indicate via electronic means that an Indicative Match Price does not exist. In addition, immediately after trading is halted in a security, and various times thereafter as determined from time to time by the PCXE, the market order Imbalance associated with the Trading Halt Auction, if any, will be published via electronic means as determined from time to time by the PCXE. If the difference between the Indicative Match Price and the last price prior to the trading halt, as determined by the Consolidated Tape, is equal to or greater than a pre-determined amount, as determined from time to time by the PCXE, Arca will assign a “SIG” designator to such Indicative Match Price and publish such designator via electronic means as determined from time to time by the PCXE.

Any Imbalance in the Trading Halt Auction may be reduced by new orders entered on the side of the market opposite the Imbalance, pursuant to the following priority: (1) market orders; (2) Limited Price Orders; and (3) Auction-Only Limit Orders. Cleanup Orders are not eligible for execution in the Trading Halt Auction. Primary Only Orders may be submitted to Arca during a trading halt for execution in the primary market. The PCXE, if it deems such

action necessary, will disseminate the time, prior to the time that orders are matched pursuant to the Trading Halt Auction, at which orders may no longer be cancelled.

During the Trading Halt Auction, Arca will interact with ITS as follows: If a pre-opening indication is required pursuant to the ITS Plan, the PCXE will disseminate three minutes prior to the Re-Opening Time the applicable price range, consisting of the Indicative Match Price as one end of the price range and the Indicative Match Price plus an amount determined by the PCXE for the higher end of the price range. Arca will treat any responses to a pre-opening indication as an Auction-Only Limit Order. In addition to ITS, other market centers may use private communication connections to enter Auction-Only Limit Orders for a Trading Halt Auction.

Arca will determine the price of the Trading Halt Auction as follows: For exchange-listed stocks, if there is no Imbalance and no other market center has re-opened trading in the security, orders will be executed in the Trading Halt Auction at the Indicative Match Price as of the Re-Opening Time. However, if an Imbalance exists, or if an equilibrium exists between buy market orders and sell market order, or if another market center has re-opened trading in the security, as many buy market orders and sell market orders as possible shall be matched, on a time priority basis, at the midpoint of the first uncrossed, unlocked NBBO, once an NBBO is available.

For Nasdaq stocks, if there is no Imbalance, orders will be executed in the Trading Halt Auction at the Indicative Match Price as of the Re-Opening Time. However, if an Imbalance exists, or if an equilibrium exists between buy market orders and sell market orders, as many buy market orders and sell market orders as possible shall be matched, on a time priority basis, once an NBBO is available: (1) at the midpoint of the NBBO at the Re-Opening Time, provided that the NBBO is not crossed; (2) at the midpoint of the first uncrossed NBBO after the Re-Opening Time, in the case in which the NBBO is crossed, but one side of the BBO is not crossed by the NBBO; (3) at the midpoint of the first uncrossed NBBO after the Re-Opening Time, in the case in which the NBBO is crossed and where both sides of the BBO are crossed by the NBBO; or (4) at the bid (offer) of the BBO that was crossed prior to the Re-Opening Time, in the case in which the BBO is crossed by a market participant.

For those issues for which the Corporation is the primary market,

orders will be executed at the Indicative Match Price at the Re-Opening Time. If equilibrium exists between buy and sell market orders, the match price shall be at the last Corporation sale price in the security regardless of the trading session. However, if the last Corporation sale price is lower than the BBO, the match price shall be the displayed bid in the security, or if the last Corporation sale price is higher than the BBO, the match price will be the displayed offer in the security.

Finally, if any orders are not executed in their entirety during the Trading Halt Auction, then such orders shall be executed in accordance with Rule 7.37 after the completion of the Trading Halt Auction. In addition, after the completion of the Trading Halt Auction, Arca will re-open for trading the previously halted security in accordance with Rule 7.

c. Miscellaneous

In addition to rule revisions related to trading in Nasdaq securities and the Trading Halt Auctions, the PCX proposes the following miscellaneous changes:

i. Rule 1—Definitions

(1) *Proposed Rules 1.1(q) and (r)*—PCXE has changed the term “orders” to “shares” in the definitions of “Imbalance” and “Indicative Match Price.”

ii. Rule 2—Equity Trading Permits

(1) *Proposed Rule 2.5*—PCXE has deleted Rule 2.5, “Publication of Approved ETP Applications.”

iii. Rule 7—Equities Trading

(1) *Proposed Rule 7.6(a), Comm. 05*—In Commentary .05 of Proposed Rule 7.6(a), PCXE has deleted the reference to a minimum price variation (“MPV”) of 1/64th of \$1.00 for those securities quoted in fractions, thereby limiting the MPV for equity securities traded on Arca to \$0.01.

(2) *Proposed Rule 7.6(a), Comm. 06*—PCXE has revised Commentary .06 to Proposed Rule 7.6(a). To clarify the applicable spread, PCXE has inserted “NBBO” into the statement that the “minimum price improvement increment (“MPII”) on the Archipelago Exchange shall be equal to \$0.01 or 10% of the NBBO spread, whichever is more.”

(3) *Proposed Rules 7.23(a)(6), 7.31(u)(1)–(2) and 7.34(b)(2)*—These proposed rules have been revised to clarify that (1) each Market Maker must maintain only one Cleanup Order and (2) Arca will submit each Cleanup Order on behalf of each Market Maker.

(4) *Proposed Rules 7.31(f)(7) and 7.31(i)(2)*—Pursuant to these two proposed rules, the Corporation shall suspend the Directed and Tracking Order Processes for a security when a locked or crossed market exists in that security. The Directed and Tracking Order Processes for that security will resume when the locked or crossed market in that security no longer exists.

(5) *Proposed Rule 7.31(s)*—PCXE has deleted the references to “Section 5 of Rule 7” from the definition of a Cross Order.

(6) *Proposed Rule 7.31(u)(6)(A)*—PCXE has deleted the phrase “of Market Orders” from paragraph (u)(6)(A) of the definition of a Cleanup Order.

(7) *Proposed Rule 7.34(b)(1)*—Proposed Rule 7.34(b)(1) has been revised to clarify that Market Makers are obligated to enter Q Orders in securities in which they are registered beginning at the start of the Core Trading Session or at such earlier time during the Opening Session as determined from time to time by the PCXE, and continuing until the end of the Core Trading Session. Market Makers are not obligated to enter Q Orders at any other times that the PCXE is open for business.

(8) *Proposed Rules 7.34(d)(1)(G), 7.35(a)(2) and 7.35(c)(2)(A)(iii)*—These proposed rules have been revised to clarify that, although the Market Order Auction occurs during the Opening Session, the following orders, which have not been designated for the Opening Session will participate in the Market Order Auction: (1) Market orders designated for the Core Trading Session and entered prior to the conclusion of the Market Order Auction and (2) Limited Price Orders designated for the Core Trading Session and entered prior to 6:28 am (Pacific Time).

(9) *Proposed Rule 7.35(c)(2)(B)*—PCXE has added “Limited Price Orders not eligible for the Opening Session” to the list of order types that may not be cancelled between 6:28 am (Pacific Time) and the conclusion of the Market Order Auction.

(10) *Proposed Rule 7.35(c)(3)(B)*—This section has been modified to indicate that, if the Market Order Auction price is based upon the NBBO under Proposed Rule 7.35(c), then the price will not be determined until an NBBO is available.

(11) *Proposed Rule 7.35(c)(3)(B)(iii)*—This subparagraph has been revised to state “at the midpoint of the first uncrossed NBBO after 6:30 am (Pacific Time), in the case of Nasdaq securities in which the NBBO is crossed but one side of the BBO is not crossed by the NBBO.”

(12) *Proposed Rule 7.35(c)(3)(B)(iv)*—Another pricing scenario has been added to the Market Order Auction. In this scenario, if an Imbalance exists, or if an equilibrium exists between buy market orders and sell market orders, as many buy market orders and sell market orders as possible shall be matched, on a time priority basis, once an NBBO is available, “at the midpoint of the first uncrossed NBBO after 6:30 a.m. (Pacific Time), in the case of Nasdaq securities in which the NBBO is crossed and where both sides of the BBO are crossed by the NBBO.”

(13) *Proposed Rule 7.35(c)(3)(B)(vi)*—PCXE has clarified the wording of Proposed Rule 7.35(c)(3)(B)(vi) to state the following: “[I]f equilibrium exists between buy and sell market orders, the match price shall be at the last Corporation sale price in the security regardless of the trading session; however, if the last Corporation sale price is lower than the BBO, the match price shall be the displayed bid in the security, or if the last Corporation sale price is higher than the BBO, the match price will be the displayed offer in the security.”

(14) *Proposed Rule 7.35(f)*—PCXE has added paragraph (f) to Proposed Rule 7.35, which reads “[w]henever in the judgment of the Corporation the interests of a fair and orderly market so require, the Corporation may adjust the timing of the auctions set forth in this Rule.”

(15) *Proposed Rule 7.36(a)(1)(B)*—PCXE has revised this paragraph to read: “The displayed portion of Reserve Orders (not the reserve size) shall be ranked at the specified limit price and the time of order entry. If the displayed portion of the Reserve Order is decremented such that 99 shares or fewer are displayed, the displayed portion of the Reserve Order shall be refreshed for (1) the displayed amount; or (2) the entire reserve amount, if the remaining reserve amount is smaller than the displayed amount, from the reserve portion and shall be submitted and ranked at the specified limit price and the new time that the displayed portion of the order was refreshed.”

(16) *Proposed Rule 7.37(b)(2)(C)*—PCXE has added the phrase “after having proceeded through Step 4” to the end of Proposed Rule 7.37(b)(2)(C).

(17) *Proposed Rule 7.37(d)(2)(A)(ii)*—In this Proposed Rule, PCXE has clarified that a marketable reserve order may be routed either (1) serially as component orders, such that each component corresponds to the displayed size or (2) only once in its entirety, including both the displayed and reserve portions.

(18) *Proposed Rule 7.43*—PCXE has added Proposed Rule 7.43, “Use of the Directed Order Process.” Proposed Rule 7.43 states that “[i]t shall be considered conduct inconsistent with just and equitable principles of trade for a User to use the Directed Order Process for the purpose of bypassing otherwise applicable fees.”

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with Section 6(b) of the Act,⁸ in general, and furthers the objectives of Section 6(b)(5),⁹ in particular, in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments and perfect the mechanisms of a free and open market 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 will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

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

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will—

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 3, including whether Amendment No. 3 is consistent with the Act. Persons

making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. 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 will also be available for inspection and copying at the principal office of the PCX. All submissions should refer to Amendment No. 3 of File No. SR-PCX-00-25 and should be submitted by May 29, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret McFarland,
Deputy Secretary.

Appendix A

April 19, 2001.

VIA MESSENGER

John Polise, Division of Market Regulation,
Securities and Exchange Commission,
Mail Stop 1001, 450 Fifth Street, N.W.,
Washington, DC 20549.

Re: *Archipelago Exchange: Supplemental Response to Comment Letters SR-PCX-00-25, Amendment No. 3*

Dear Mr. Polise: On behalf of the Pacific Exchange, Inc., via its wholly owned subsidiary PCX Equities, Inc., (collectively, “PCX”), we appreciate the opportunity to respond to the comment letters submitted to the Securities and Exchange Commission (“SEC” or “Commission”) regarding the Archipelago Exchange (“ArcaEx”) rule filing.¹¹

To date, nine commenters have submitted ten comment letters concerning ArcaEx.¹²

¹⁰ 17 CFR 200.30-3(a)(12).

¹¹ See Arca Proposing Release, note 3, *supra*.

¹² Letter from Michael T. Dorsey, Senior Vice President, General Counsel and Secretary, Knight Trading Group, Inc., to Jonathan G. Katz, Secretary, SEC, dated Feb. 9, 2001 (“Knight Letter”); Letter from Steve Wunsch, President, Arizona Stock Exchange (“AZX”), to Jonathan G. Katz, Secretary, SEC, dated Feb. 1, 2001 (“AZX Letter”); Letter from Robert R. Glauber, Chief Executive Officer and President, NASD Regulation, Inc. (“NASDR”), to Jonathan G. Katz, Secretary, SEC, dated Jan. 26, 2001 (“NASDR Letter”); Letter from Richard G. Ketchum, President, Nasdaq, to Jonathan G. Katz, Secretary, SEC, dated Jan. 22, 2001 (“Nasdaq II Letter”); Letter from Jeffrey T. Brown, Cincinnati Stock Exchange (“CSE”), to Jonathan G. Katz, Secretary, SEC, dated Jan. 8, 2000 (“CSE Letter”); Letter from David Hultman, D.A. Davidson & Co., to Jonathan G. Katz, Secretary, SEC, dated Jan. 5, 2000 (“D.A. Davidson Letter”); Letter from Los Angeles Specialists Association (“LASA”), to

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

Five commenters fully supported the proposal.¹³ Of these five favorable letters, three represented PCX members. For example, the Los Angeles and San Francisco Specialists Associations stated that they “strongly support the PCX’s proposal and urge the [Commission] to approve this proposal as soon as possible.”¹⁴ Similarly, D.A. Davidson wrote that it “applauds the effort to create a New Marketplace which will level the playing field for all participants.”¹⁵ In addition to member support, the ArcaEx proposal was received favorably by two established electronic marketplaces—the Cincinnati Stock Exchange (“CSE”) and the Arizona Stock Exchange (“AZX”). The CSE “believes that the PCX proposal is an innovative approach that seeks to challenge the floor-based exchange models for the benefit of public investors.”¹⁶ The AZX urged the Commission “to expedite the PCX proposed rule change” because it believes that it will help to resolve pressing market structure issues.¹⁷

In contrast, three commenters, including two traditional markets—Nasdaq and the Philadelphia Stock Exchange (“Phlx”)—and a wholesale market maker, Knight Trading Group, Inc. (“Knight”) opposed the ArcaEx rule change.¹⁸ In addition, NASD Regulation, Inc., (“NASDR”) submitted a comment letter, but did not express a view in favor of or in opposition to the filing.¹⁹ In this letter, the PCX addresses the various concerns expressed by the commenters, particularly Nasdaq, Phlx and Knight, about the ArcaEx proposal. As discussed in detail below, the PCX does not believe any of the concerns raised in the comment letters should serve as an impediment to approval of the rule filing.

I. ArcaEx is Properly Regulated as a Facility of an Exchange

The PCX believes that, contrary to Nasdaq’s assertions,²⁰ ArcaEx is properly regulated as a facility of an exchange and not as an exchange itself. Section 3(a)(2) of the Securities Exchange Act of 1934 (“Exchange Act”) provides that:

the term “facility” when used with respect to an exchange includes 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 ticket 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.

ArcaEx will use PCX equipment and personnel²¹ and involve the participation of PCX market makers. Furthermore, executions performed on ArcaEx will be regulated and reported as PCX trades. In addition, by supplying an electronic trading system for the use of the PCX members and their customers, ArcaEx will provide a “service * * * for the purpose of effecting * * * a transaction on an exchange,” thus providing the PCX the “right of the exchange to the use of * * * [such] service.” Because effecting and reporting ArcaEx matches involves the PCX’s premises, property and services, ArcaEx will meet the definition of a “facility” of an exchange as defined in Section 3(a)(2) of the Exchange Act.

Regulating ArcaEx as a “facility” of the PCX is consistent with the approach the Commission has followed in other cases similar to the PCX and ArcaEx situation. For example, the Commission approved the PCX’s proposal to establish an exchange facility called the PCX Application of the OptiMark System, which was a trading system owned and operated by an entity other than an exchange.²² Likewise, the Phlx, itself, has contracted with third parties to establish the VWAP Trading System as a facility of the Phlx.²³ In neither of these circumstances did the Commission require the entities which contracted with the exchanges to create a facility to register as national securities exchanges themselves.

Because ArcaEx is a facility of the PCX, a rule filing conforming to the requirements of Section 19 of the Exchange Act and Rule 19b-4 thereunder is the appropriate regulatory format for soliciting comments and seeking Commission approval of the arrangement.²⁴ Despite Nasdaq’s statements

to the contrary,²⁵ there is no need to file a Form 1 for ArcaEx because the PCX is already registered as a national securities exchange. Again, the use of a Rule 19b-4 filing for the creation of a new exchange facility follows the procedure used, and accepted by the Commission, with regard to other exchange facilities.²⁶ Correspondingly, PCX, as the registered national securities exchange for the facility, will amend its Form 1 to the extent revision is required by Rule 6a-2 under the Exchange Act for the creation of the ArcaEx facility.²⁷

II. The Relationship Between PCX and the ArcaEx Facility Satisfies the Regulatory Requirements of the Exchange Act

The PCX believes that ArcaEx, as a facility of the PCX, is designed to operate in a manner that is consistent with the regulatory purposes of the Exchange Act. Nasdaq’s concerns about ArcaEx’s compliance with the securities laws as well as the SEC’s ability to oversee the ArcaEx facility are unfounded.²⁸ The relationship between PCX and the ArcaEx facility—in both a rules-related context and a contractual context—ensures ArcaEx’s compliance with the securities laws.

First and foremost, the PCX will be fully responsible for all activity that takes place through ArcaEx, including its regulation and oversight, because ArcaEx is a part of the exchange.²⁹ The PCX will comply with its obligations under the Exchange Act with regard to ArcaEx, just as it does with its current trading facilities.³⁰

Second, ArcaEx, as a party that has agreed to operate a facility of a self-regulatory organization, is required to cooperate with the PCX in meeting its regulatory responsibilities and to submit to Commission oversight and examination. Such cooperation and oversight will be assured through the application of proposed PCXE Rule 14.3 of the PCX Plan of Delegation.³¹ Proposed PCXE

²⁵ Nasdaq II Letter at 1–3.

²⁶ See, e.g., PCX OptiMark Release and VWAP Release. See also Nasdaq OptiMark Release and Chicago Match Release.

²⁷ Knight’s argument that PCX’s reliance on unlisted trading privileges is in some way inappropriate is incorrect. Knight Letter at 4. Under the Exchange Act, the PCX, as a registered national securities exchange, may trade securities listed on the PCX and/or securities admitted to unlisted trading privileges. See generally Section 12 of the Exchange Act.

²⁸ Nasdaq II Letter at 3–6.

²⁹ In response to Nasdaq’s conflict of interest concerns regarding ArcaEx (see Nasdaq II Letter at 5), we note that the PCX will rely solely on its own regulatory staff to perform any regulatory functions concerning ArcaEx. In that vein, no employees of Archipelago Exchange, L.L.C., or Archipelago Holdings, L.L.C., nor any dual employees of PCX and the ArcaEx companies will be involved in regulatory oversight. Furthermore, all PCX regulatory staff must act in accordance with strict standards of confidentiality with regard to ArcaEx, just as they must in all their oversight dealings.

³⁰ See Section 6(b)(1) of the Exchange Act (the PCX will “comply * * * with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange”).

³¹ Proposed PCXE Rule 14.3 is based on the NASD’s Plan of Allocation and Delegation of Functions by NASD to Subsidiaries.

Jonathan G. Katz, Secretary, SEC, dated Jan. 4, 2000 (“LASA Letter”); Letter from San Francisco Specialists Association (“SFSA”), to Jonathan G. Katz, Secretary, SEC, dated Jan. 3, 2000 (“SFSA Letter”); Letter from John F. Malitzis, Associate General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, SEC, dated Dec. 28, 2000 (“Nasdaq I Letter”); and Letter from Lanny A. Schwartz, Executive Vice President and General Counsel, Philadelphia Stock Exchange (“Phlx”), to Jonathan G. Katz, Secretary, SEC, dated Dec. 21, 2000 (“Phlx Letter”).

¹³ See AZX Letter; CSE Letter; D.A. Davidson Letter; SFSA Letter; and LASA Letter.

¹⁴ SFSA Letter at 1 and LASA Letter at 1.

¹⁵ D.A. Davidson Letter at 1.

¹⁶ CSE Letter at 1.

¹⁷ AZX Letter at 1.

¹⁸ See Knight Letter; Nasdaq II Letter; Phlx Letter; and Nasdaq I Letter.

¹⁹ See NASDR Letter.

²⁰ Nasdaq II Letter at 1–3.

²¹ As the Commission noted previously in other contexts, the PCX’s use of Archipelago Exchange, L.L.C., personnel and equipment does not alter the determination that ArcaEx should be regulated as a facility. See Securities Exchange Act Release No. 41210 (Mar. 24, 1999), 64 FR 15857 (Apr. 1, 1999) (approval order of Phlx’s VWAP Trading System) (“VWAP Release”) (“The Commission notes that the Exchange’s use of [Universal Trading Technologies Corporation’s] personnel and equipment in operating the [VWAP] System does not alter the Commission’s determination that the System is properly regulated as a facility of the Exchange.”).

²² See Securities Exchange Act Release No. 39086 (Sept. 17, 1997), 62 FR 50036 (Sept. 24, 1997) (“PCX OptiMark Release”). See also Securities Exchange Act Release No. 41967 (Sept. 30, 1999), 64 FR 54704 (Oct. 7, 1999) (approval order for Nasdaq Application of OptiMark System) (“Nasdaq OptiMark Release”); Securities Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141 (Dec. 7, 1999) (approval order for Chicago Match System) (“Chicago Match Release”).

²³ VWAP Release.

²⁴ Similarly, pursuant to the requirements of Section 19 of the Exchange Act, the PCX intends to set forth in a separate rule filing the fees that will be charged for the use of ArcaEx services. See Knight Letter at 2–3.

Rule 14.3(a), which applies to Archipelago Exchange, L.L.C., ("Archipelago Exchange"), the operator and owner of the ArcaEx trading system, states:

The books, records, premises, officers, directors, agents and employees of Archipelago Exchange, L.L.C., shall be deemed to be the books, records, premises, officers, directors, agents and employees of PCX and PCX Equities for purposes of and subject to oversight pursuant to the Securities Exchange Act. The books and records of Archipelago Exchange, L.L.C., shall be subject at all times to inspection and copying by the PCX, PCX Equities and the SEC.

By legally equating the premises, personnel and records of Archipelago Exchange with those of the PCX, both the PCX and the SEC have jurisdiction over Archipelago Exchange's premises, personnel and records to the same extent that the PCX and the SEC have jurisdiction over the PCX's premises, personnel and records.

In addition, proposed PCXE Rule 14.3(b) further enhances the SEC and PCX's ability to oversee all relevant aspects of the ArcaEx facility. Under this rule, the SEC and the PCX are granted access, not only to the operator of ArcaEx, but also to the parent company of the operator, Archipelago Holdings, L.L.C. ("Holdings"). Specifically, proposed PCXE Rule 14.3(b) states that "[a]ll officers and directors of Archipelago Holdings, L.L.C., shall be deemed to be officers and directors of PCX and PCX Equities for purposes of and subject to oversight pursuant to the Securities Exchange Act."

Finally, the SEC and PCX's access to and oversight of ArcaEx's operating company and its parent is further solidified in the private contracts related to ArcaEx. Each of the clauses in Rule 14.3 is included in the agreements between PCX and Archipelago Exchange and Holdings. Therefore, Archipelago Exchange and Holdings have a private contractual obligation as well as a regulatory obligation to abide by Rule 14.3.

The relationship between the PCX and ArcaEx is structured in the same fashion as other facility arrangements between an exchange and third parties.³² Such facility arrangements have proven effective in the past and there is no reason to believe that the oversight quality will be hampered in any way in the present case.

III. PCX Will Conduct All Necessary Surveillance of ArcaEx

As part of its obligations under the Exchange Act and pursuant to its own rules,³³ the PCX will conduct all necessary surveillance of the operation of and trading through ArcaEx, including a full audit trail capability. In doing so, ArcaEx, like all facilities of an exchange, will be subject to full oversight of the SEC. Pursuant to this oversight, the SEC will ensure that the PCX's surveillance program is adequate based on all relevant circumstances. Nevertheless, such an evaluation of a surveillance program is not

accomplished via the public comment process of a Rule 19b-4 filing. Notwithstanding this fact, PCX emphasizes that it has, not only the technological capability to establish and maintain an audit trail, but also the staff expertise and capital resources to satisfactorily oversee a new electronic market trading an increased number of securities. Therefore, the commenters' expressed fears that PCX is unprepared to regulate ArcaEx are unfounded.³⁴

PCX, as a well-established exchange, has the requisite staff experience to support and to supplement the technological surveillance necessary for the all-electronic ArcaEx. Throughout its long trading history, PCX has succeeded in attracting qualified management and regulatory staff, who have repeatedly demonstrated their familiarity with the federal securities laws and the self-regulatory role of a registered exchange. Furthermore, the PCX personnel have had the opportunity to hone their regulatory skills in both floor and electronic trading environments, like the PCX Application of OptiMark, making them particularly well-suited to the task at hand.

Furthermore, consistent with the requirements of the Exchange Act, PCX will demonstrate to the SEC, as necessary, that it has adequate financial resources to fund a surveillance program for a fully electronic trading facility. Finally, PCX intends to implement a state-of-the-art electronic system for producing detailed audit trails of all orders submitted to ArcaEx. In accordance with its regulatory responsibilities, PCX will demonstrate to the Commission that the technology of the system will be more than adequate for the surveillance of, and trading on, ArcaEx.³⁵

IV. The Exchange Act Does Not Require a Market Maker in Every Security

Contrary to Nasdaq's assertion that a failure to require a market maker in every security is a "clear statutory deficiency,"³⁶ the Exchange Act neither explicitly nor implicitly makes such a demand on an exchange.³⁷ First, no specific provision of the

Exchange Act, including Sections 6 or 11A, or any rules and regulations promulgated thereunder, compel an exchange to employ market makers as a source of liquidity.

Second, current established trading practices also support the notion that a market maker need not be registered in every security traded on an exchange. The Commission permits exchanges to trade securities via cabinet trading programs.³⁸ With cabinet trading, buy and sell limit orders are booked for execution on the exchange and executed outside the regular specialist or market maker system. ArcaEx should not be held to a different standard than that applied to traditional exchanges.

Third, no market maker requirement can be implied from the basic definition of what constitutes an exchange. Nasdaq claims that because "provid[ing] a ready source of liquidity" is "the most fundamental requirement of a securities exchange," every exchange must require a market maker or specialist to be assigned to each security listed on that market.³⁹ The Commission, however, specifically has rejected this argument in its discussion of the basic characteristics of an "exchange" in the ATS Release.⁴⁰

Nasdaq's argument is merely a reiteration of the now-discarded definition of an "exchange" promulgated in the Delta Release.⁴¹ In 1990, the Commission interpreted the statutory definition of an exchange narrowly to include only those organizations that were "designed * * * to centralize trading and provide buy and sell quotations on a regular and continuous basis so that purchasers and sellers have a reasonable expectation that they can regularly execute their orders at those price

³⁸ For example, PCXE Rule 7.20 states that

[t]he Corporation may designate to be traded in the CABINET System those securities which in the judgment of the Corporation do not trade with sufficient frequency to warrant their retention in the specialist system * * *. Bids and offers in securities dealt in by use of cabinets shall be written on floor tickets which shall be filed in the cabinets in the following sequence: 1. According to price, and 2. According to the time received at the CABINET. Orders, including all bids and offers, in such securities shall be filled in the sequence indicated above.

PCX Rule 7.20. For other examples of cabinet trading rules, *see, e.g.*, CHX Art. XX, Rule 11 and CSE Rule 11.7.

³⁹ Nasdaq II Letter at 10.

⁴⁰ *See generally* Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998) ("ATS Release"). In redefining the term "exchange" in the ATS Release, the Commission concluded that the fundamental characteristics of an exchange are: (1) bringing together the orders for securities of multiple buyers and sellers; and (2) using established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade. *See* Rule 3b-16 under the Exchange Act. Indeed, despite critical comments by several commenters, the Commission rejected the "liquidity" standard Nasdaq now seeks to resurrect.

⁴¹ Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1980, 1900 (Jan. 19, 1990) ("Delta Release"). *See also* Board of Trade of the City of Chicago v. SEC, 923 F.2d 1270 (7th Cir. 1991).

³² *See, e.g.*, PCX OptiMark Release.

³³ *See, e.g.*, Section 6(b)(5) of the Exchange Act (the exchange must have rules designed to prevent, among other things, "fraudulent and manipulative acts and practices [and] to promote just and equitable principles of trade").

³⁴ Knight Letter at 4 and Nasdaq II Letter at 7-9. *See also* NASDR Letter.

³⁵ In addition, PCX will cooperate with the Commission's Automation Review Policy with regard to ArcaEx. *See* Securities Exchange Act Release No. 27445, 54 FR 48703 (Nov. 24, 1989) ("ARP I Release") and Securities Exchange Act Release No. 29185, 56 FR 22490 (May 15, 1991) ("ARP II Release"). Specifically, in accordance with the details of ARP I and ARP II, PCX will ensure that ArcaEx has "the capacity to accommodate current and reasonably anticipated future trading volume levels adequately and to respond to localized emergency conditions." ARP I Release at 48705-06.

³⁶ Nasdaq II Letter at 10.

³⁷ Similarly, we note that, in the ArcaEx Proposing Release, the Commission requested comment on the minimum price improvement provided by ArcaEx in cross and directed orders. ArcaEx Proposing Release at 78836-37. We believe that the proposed crossing and directed order procedures were well designed in that they provide the customer with the best displayed quote within ArcaEx plus a minimum increment. We believe this is consistent with the Exchange Act and encourage the Commission to approve the proposal.

quotations.”⁴² In 1998, in light of the rapid technological changes taking place in the securities industry, the Commission rescinded the Delta definition and expressly rejected liquidity provided by markets makers as a defining characteristic of a securities exchange. In reaching this conclusion, the Commission explained that “while the Delta interpretation was appropriate at the time, its emphasis on the ‘expectation’ of regular execution of orders at quoted prices no longer reflects today’s markets where alternative trading systems compete directly with registered exchanges and Nasdaq.”⁴³ The Commission further clarified that:

More fundamentally, although traditional exchanges still provide liquidity through two-sided quotations and, hence, raise an expectation of execution at the quoted price, this is no longer the essential characteristic of a securities market where stock and other securities exchange hands. Today’s technology enables market participants and investors to tap simultaneous and multiple sources of liquidity from remote locations. Market makers and specialists may be important liquidity providers on a particular exchange, but liquidity now comes from many sources.⁴⁴

Furthermore, when the Commission broadened the definition of an exchange to include a greater variety of business models, it did so with the intent of “encouraging innovative new markets”⁴⁵ and fostering the development of new technology-driven trading designs. ArcaEx is such an “innovative” market and, therefore, there is no basis for commanding ArcaEx to alter its computer-based architecture to require market makers in every security.

V. The Alternative Order Routing Methods of ArcaEx Expand Investor Choice in a Manner Consistent with the Exchange Act

Nasdaq and Knight questioned the status and function of the Archipelago electronic communications network⁴⁶ (“ECN”) after the creation of ArcaEx.⁴⁷ The broker-dealer commonly referred to as the Archipelago ECN will continue to exist as a registered broker-dealer renamed WAVE. The functions and activities of WAVE, however, will differ from the current activities of the Archipelago ECN. In particular, WAVE will perform three primary functions, including acting as (1) for a limited period of time, a residual ECN, (2) an introducing broker and (3) a routing broker. In order to perform these limited functions, WAVE will exist as an entity separate and distinct from ArcaEx. In addition, NASDR, rather than PCX, will be the Designated Examining Authority (“DEA”) for WAVE, just as it has been for the Archipelago ECN. We discuss the proposed

business and regulation of WAVE in more detail below.

A. WAVE Will Perform Three Primary Functions

1. WAVE Will Continue to Perform as an ECN for a Limited Period of Time

First, as a temporary matter, WAVE will continue to act as an ECN, to the extent necessary, for a limited period of time. Specifically, PCX and Archipelago have agreed that all securities eligible to be traded on ArcaEx (*i.e.*, listed securities or securities with unlisted trading privileges (“UTP”)) will be traded only on ArcaEx; they will not be traded on PCX and the ECN. Therefore, no security will be traded concurrently on both ArcaEx and the ECN. As of this date, however, the plan for trading over-the-counter (“OTC”) pursuant to UTP (the so-called “OTC/UTP Plan”) only permits PCX, as an exchange participating in the Plan, to trade 1000 of the Nasdaq/NM securities.⁴⁸ Until the OTC/UTP Plan has been expanded to incorporate all Nasdaq securities,⁴⁹ WAVE will continue to act as an ECN for those securities excluded from the Plan. Once the OTC/UTP Plan has been expanded—which is expected to occur later this year—the remaining Nasdaq securities will be transferred for trading from the Archipelago ECN to ArcaEx pursuant to a roll-out plan. The ECN will cease to operate as such once all the Nasdaq securities have been transferred to ArcaEx.

2. WAVE Will Act as an Introducing Broker

Second, WAVE plans to register as an ETP Holder and act as an introducing broker for institutions or other entities who are not ETP Holders themselves. WAVE’s position as the routing broker will not bestow any special status on WAVE in its capacity as an ETP Holder. WAVE, acting as an ETP Holder, and its customers will have the exact same access to ArcaEx as any other ETP Holder and its customers. In this regard, PCX and Archipelago will establish appropriate information barriers to address any concerns regarding WAVE’s status relative to other ETP Holders.

3. WAVE Will Supply ArcaEx With a Routing Service

Finally, the ongoing WAVE function most relevant for ArcaEx is a routing service. WAVE will route orders, as necessary, from ArcaEx to other market centers.⁵⁰ Given various technical issues associated with market center-to-market center routing within the strictures of today’s intermarket structure, PCX and Archipelago have opted to employ the services of a routing broker, rather than rely on routing orders to other markets directly from PCX itself.

Despite the decision to employ WAVE in this intermarket capacity, no User is required to utilize the WAVE routing services. Furthermore, those Users who opt out of the WAVE routing services are not precluded

from entering any order types, except a very limited subset of orders that specifically incorporates a WAVE routing requirement within the definition of the order. This limited subset includes Primary Only Orders as well as NOW Orders, if routing of the NOW Order is required.⁵¹ The only trading condition for those Users who do not use the WAVE routing services is that each order, if it has not been fully executed after it has progressed through each step of the ArcaEx trading algorithm,⁵² must be returned to the User or the User’s designated agent prior to reaching the routing step of the algorithm.⁵³ After the order is returned to the User, the User may then route the order to another market center as the User sees fit. In other words, the trading mechanism is the same for orders that do not rely on WAVE and orders that do rely on WAVE, except orders that do not rely on WAVE, of course, must, by definition, be routed outside of ArcaEx through another mechanism. The specifics of the routing function and its impact on ArcaEx Users are discussed in more detail below.

i. ArcaEx Provides Its Users With a Choice as to How Their Orders Will Be Routed to Away Markets

ArcaEx has been designed to provide its Users with a choice as to how they wish to route orders to away markets. In this regard, Nasdaq and Knight misinterpret the various options available to Users in ArcaEx’s routing structure.⁵⁴ These two commenters correctly identify one ArcaEx routing option: a User may choose to utilize the routing services provided by WAVE, the broker-dealer affiliate of Archipelago Exchange, L.L.C. To do so, the User must enter into a routing agreement with WAVE under which WAVE “agrees to act as agent for routing orders of the ETP Holder⁵⁵ and the ETP Holder’s Sponsored Participants⁵⁶ entered into the Archipelago Exchange to other market centers or broker-dealers for execution, whenever such routing is required.”⁵⁷

Nasdaq and Knight, however, fail to recognize that a User is not required to use WAVE’s routing services. Instead of signing a routing agreement with WAVE, a User may bypass WAVE entirely and opt to rely on its

⁵¹ See Proposed PCXE Rule 7.31(x).

⁵² See generally Proposed PCXE Rule 7.37.

⁵³ See Proposed PCXE Rule 7.37(d) (describing “Routing Away,” Step 5 of the trading algorithm, after the Directed Order, Display Order, Working Order and Tracking Order Processes).

⁵⁴ Knight Letter at 4–5 and Nasdaq II Letter at 6–7.

⁵⁵ An “ETP” is an Equity Trading Permit issued by the PCXE for effecting approved securities transactions on the PCXE’s Trading Facilities. Proposed PCXE Rule 1.1(m). An “ETP Holder” is “a sole proprietorship, partnership, corporation, limited liability company or other organization in good standing that has been issued an ETP. An ETP Holder must be a registered broker or dealer pursuant to Section 15 of the Exchange Act.” See Proposed PCXE Rule 1.1(n).

⁵⁶ A “Sponsored Participant” means “a person which has entered into a sponsorship arrangement with a Sponsoring ETP Holder pursuant to [Proposed PCXE] Rule 7.29.” Proposed PCXE Rule 1.1(jj).

⁵⁷ Proposed PCXE Rule 1.1(gg).

⁴² Delta Release at 1900.

⁴³ ATS Release at 70899.

⁴⁴ ATS Release at 70899 (emphasis added).

⁴⁵ ATS Release at 70845.

⁴⁶ See, e.g., Letter from Robert L. D. Colby, Division of Market Regulation, SEC, to Gerald Putnam, Archipelago, L.L.C., dated Jan. 12, 2001.

⁴⁷ Knight Letter at 5, n. 13, and Nasdaq II Letter at 9.

⁴⁸ See, e.g., Securities Exchange Act Release No. 43545 (Nov. 9, 2000), 65 FR 69581 (Nov. 17, 2000).

⁴⁹ *Id.* (the PCX request to expand the number of eligible Nasdaq/NM securities).

⁵⁰ See, e.g., Proposed PCXE Rules 1.1(gg), 7.32 and 7.37(d).

own routing abilities or those of another broker-dealer by utilizing the Fill-or-Return, Fill-or-Return Plus or Post No Preference ("PNP") order types⁵⁸ supplied by ArcaEx.⁵⁹ A Fill-or-Return order is "[a]n order to buy or sell that is to be executed in whole or in part on the Corporation, and the portion not so executed is to be cancelled, without routing the order to another market center."⁶⁰ A Fill-or-Return order, therefore, allows the order originator to re-route the order to another market in a manner of its own choosing, once it is informed that the order has not been executed in its entirety on the ArcaEx. This alternative allows the User to implement its own customized means for accomplishing the order routing.

Similarly, a User may wish to rely upon the routing capabilities of another entity, rather than its own routing resources or WAVE. ArcaEx facilitates such relationships by providing a User with the opportunity to enter Fill-or-Return Plus orders into ArcaEx. A Fill-or-Return Plus order is:

[a]n order to buy or sell that is to be executed in whole or in part on the Corporation, and the portion not so executed is to be cancelled, without routing the order to another market center or market participant. In the event any portion of the order is not executed on the Corporation and must be cancelled, the Archipelago Exchange, after canceling the unexecuted portion of the order, shall send an administrative message to an ETP Holder designated by the order entry ETP Holder informing the designated ETP Holder that a portion of the order was cancelled.⁶¹

The administrative message informs the designated ETP Holder that an order has not been executed. The designated ETP Holder may then use this information to send an order via its own routing mechanisms to another market in accordance with the original User's instructions.

Finally, a User may prefer to send PNP Orders to ArcaEx. A PNP Order is "a limit order to buy or sell that is to be executed in whole or in part on the Corporation, and the portion not so executed is to be ranked in the Arca Book, without routing any portion of the order to another market center; provided, however, the Corporation shall cancel a PNP that would lock or cross the NBBO."⁶² This order type provides the User with the ability to use ArcaEx as a final order destination when it suits the User's investment needs.

As Nasdaq and Knight note in their comment letters,⁶³ certain order types which involve a routing element unique to ArcaEx, like the Primary Only Order,⁶⁴ require the User to utilize WAVE's routing services. As discussed above, however, the rules for trading on ArcaEx in no way preclude a User from pursuing trading opportunities similar to those provided by ArcaEx orders through the routing services supplied by broker-dealers other than WAVE. Users easily may do so by entering Fill-or-Return or Fill-or-Return Plus orders. Furthermore, no denial of access issues arise with any order type, regardless of their routing mechanism.⁶⁵ Every User must satisfy identical, objective requirements for submitting each order type; the requirements do not vary based on the identity of the User or otherwise unfairly discriminate against any particular class of Users.⁶⁶

ii. WAVE Will Not Enjoy a Competitive Advantage as a Result of its Routing Services

Contrary to the concerns expressed by Nasdaq and Knight,⁶⁷ WAVE will not enjoy a competitive advantage over other broker-dealers as a result of the routing services it provides to ArcaEx. In addition to providing only one of the methods by which Users may route orders to away markets, as discussed above, WAVE will be limited in what trading activities it may perform. WAVE will not, for example, conduct proprietary transactions on ArcaEx or in securities traded on ArcaEx. Furthermore, information barriers will be maintained, as necessary, to ensure that WAVE may not unfairly take advantage of knowledge gained as the ArcaEx routing broker.

B. WAVE Will Be Separate and Distinct From ArcaEx

WAVE and ArcaEx will be separate and distinct corporate entities (WAVE, L.L.C., and Archipelago Exchange, L.L.C., respectively). As mentioned above, both are wholly-owned subsidiaries of the same holding company, Archipelago Holdings, L.L.C., whose officers and directors are deemed to be officers and directors of PCX and PCXE for purposes of the Exchange Act. As such WAVE and ArcaEx each have their own trading systems as well as their own compliance, finance and sales functions.

C. WAVE Will Be Assigned to a Designated Examining Authority Other Than the PCX

Nasdaq expressed concerns about the heightened potential for conflicts of interest if the PCX were to regulate WAVE.⁶⁸ To avoid even the perception of a conflict of interest, PCX agrees that an SRO other than PCX should be WAVE's DEA. In particular, PCX and Archipelago believe that NASDR is the most appropriate SRO to act as WAVE's DEA. Based on discussions with NASDR, PCX understands that NASDR has agreed to undertake the DEA responsibilities with respect to WAVE.

VI. ArcaEx Operates in Compliance With Section 11(a) of the Securities Exchange Act

The Phlx believes that PCX should not abandon priority for public customer agency orders over proprietary orders of broker-dealers in implementing ArcaEx.⁶⁹ The Phlx argues that the requirement that broker-dealer orders yield priority, parity and precedence to customer orders is a statutory requirement under Section 11(a) of the Exchange Act.⁷⁰ The PCX disagrees. As discussed in detail in *Appendix A*, the order execution algorithm of ArcaEx complies with the requirements of, and satisfies the policy concerns underlying, Section 11(a) without requiring public customer priority.

Section 11(a) of the Exchange Act prohibits a member of a national securities exchange from effecting transactions on the exchange for its own account, the account of an associated person, or an account in which it or an associated person exercises investment discretion (collectively, "covered accounts"), unless an exception applies. In enacting this provision, Congress was concerned about members benefiting in their principal transactions from special "time and place" advantages associated with floor trading—such as the ability to "execute decisions faster than public investors."⁷¹ The Commission, however, has adopted a number of exceptions to the general statutory prohibition for situations in which the principal transactions contribute to the fairness and orderliness of exchange markets or do not reflect any time and place trading advantages.

The Phlx apparently assumes that the PCX is relying upon the Section 11(a) exception set forth in Rule 11a1-1(T) ("the proprietary trading rule"), which has, as one of its requirements, public customer priority. PCX, however, believes that ArcaEx satisfies the requirements of another exception to Section 11(a), which does not require public

⁵⁸ For a definition of the Fill-or-Return, Fill-or-Return Plus or PNP order types, see, respectively, Proposed PCXE Rules 7.31(p), 7.31(r) and 7.31(w).

⁵⁹ See Proposed PCXE Rule 7.32. ArcaEx's provision of alternative routing services other than WAVE is akin to Nasdaq's efforts regarding SuperMontage to allow Nasdaq members to establish order routing arrangements with other market participants, such as telephone access or direct links, in addition to, or in place of, SuperMontage's routing arrangements. See Securities Exchange Act Release No. 43863 (Jan. 19, 2001), 66 FR 8020, 8049 (Jan. 26, 2001) ("SuperMontage Release").

⁶⁰ Proposed PCXE Rule 7.31(p).

⁶¹ Proposed PCXE Rule 7.31(r).

⁶² See Proposed PCXE Rule 7.31(w).

⁶³ Knight Letter at 4–5 and Nasdaq II Letter at 11–12.

⁶⁴ See Proposed PCXE Rule 7.31(x) ("For exchange listed securities, [a Primary Only Order] is a market order that is to be routed as a market-on-open order to the primary market for participation in the primary market opening process").

⁶⁵ See Nasdaq II Letter at 11–12.

⁶⁶ E.g., Section 6(b)(5) of the Exchange Act (the rules of an exchange may not be designed to permit "unfair discrimination"); ATS Release at 70874 (standards for access "should act to prohibit unreasonably discriminatory denials of access. A denial of access is reasonable if it is based on objective standards."). See Section 19(f) of the Exchange Act.

⁶⁷ See Knight Letter at 5 and Nasdaq II Letter at 9.

⁶⁸ Nasdaq II Letter at 6–7.

⁶⁹ See Phlx Letter.

⁷⁰ *Id.* The Phlx also asserts that customer priority is a Congressional directive. The PCX has found no securities law requirement that would force ArcaEx to incorporate customer priority into its trading algorithm.

⁷¹ See Securities Exchange Act Release No. 14563 (Mar. 14, 1978), 43 FR 11542, 11543 (Mar. 17, 1978) ("1978 Release I"); Securities Exchange Act Release No. 14713 (Apr. 27, 1978), 43 FR 18557, 18588 (May 1, 1978) ("1978 Release II"); Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 FR 6084, 6092 (Jan. 31, 1979) ("1979 Release"). The 1978 and 1979 Releases cite the House Report at 54–57.

customer priority. This alternative exception is Rule 11a2-2(T), commonly referred to as the "effect versus execute" rule.⁷²

The effect versus execute rule imposes four requirements "designed to put members and non-members on the same footing, to the extent practicable, in light of the purposes of Section 11(a)." ⁷³ ArcaEx will place all of its Users—both ETP Holders and non-ETP Holders—on the "same footing," as intended by Rule 11a2-2(T). Given ArcaEx's automated matching and execution services, no User will enjoy any special control over the timing of execution or special order handling advantages, as all orders will be centrally processed for execution by computer, rather than being handled by a member through bids or offers made on the trading floor. Because ArcaEx's open, electronic structure is designed to prevent any ETP Holders from gaining any time and place advantages, the PCX believes that ArcaEx satisfies the four requirements of the "effect versus execute" rule as well as the general policy objectives of Section 11(a).⁷⁴

This result is consistent with the Commission's application of the effect versus execute rule in similar situations. In the past, the Commission and its staff have allowed exchanges to sponsor innovative trading systems in reliance on Rule 11a2-2(T), finding that such facilities, by design, do not provide any special time and place advantage to members.⁷⁵ In particular, where the execution is performed by the facility itself through an automated service, it has been determined that "the member would not retain any ability to control the timing of the execution or otherwise enjoy the kind of special order-handling advantages inherent in being on an exchange floor."⁷⁶ Like these

trading systems, ArcaEx ensures that ETP Holders do not have any special or unique trading advantages and, therefore, complies with Section 11(a).

VII. The Treatment of Discretionary Orders in ArcaEx Complies With the Firm Quote Rule

In its comment letter, Nasdaq questioned whether ArcaEx's discretionary orders comply with Rule 11Ac1-1 under the Securities Exchange Act, the so-called Quote Rule.⁷⁷ Under the proposed PCXE Rules, a discretionary order is defined as "an order to buy or sell a stated amount of a security at a specified, undisplayed price (the 'discretionary price'), in addition to, at a specified, displayed ('displayed price')." ⁷⁸ For all non-marketable discretionary orders, the discretionary order will be displayed to all Users at the displayed price. No Users will see the discretionary price of the orders. An undisplayed, discretionary price order will be afforded price priority in the Arca Book, but not time priority relative to displayed orders.⁷⁹ As discussed in more detail in *Appendix B*,⁸⁰ the PCX believes that its discretionary orders, not only comply with the requirements of the Quote Rule, but also provide significant benefits to the markets.

The Quote Rule mandates national securities exchanges, subject to certain exceptions, to collect and disseminate "best bids" and "best offers" from a "responsible broker or dealer."⁸¹ ArcaEx's treatment of discretionary orders complies with the requirements of this Rule for a number of reasons. First, an important attribute of a bid or offer subject to the Quote Rule is that it represents the "bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer."⁸² Accordingly, "[i]n order to constitute a bid or offer, the underlying trading interest must have been communicated to at least one potential counterparty."⁸³ On ArcaEx, the discretionary price of a discretionary order is not communicated to any Users of the system; only ArcaEx is aware of the full potential trading interest of these orders until trades occur. Accordingly, because ArcaEx does not publish the discretionary aspect of these discretionary orders, they should not be deemed to be a "bid or offer" within the meaning of the Quote Rule.

Second, discretionary orders allow the investor to express a more complex—and more accurate—trading interest than the single price and size of a conventional order.⁸⁴ Unlike "bids" and "offers,"

discretionary orders reflect the fact that there is usually more than one price at which an investor is willing to buy or sell. Because these discretionary orders represent a qualitatively different set of information from the traditional price and size information, they are more analogous to indications of interest, than bids and offers. Therefore, like indications of interest, discretionary orders should be excluded from the requirements of the Quote Rule.⁸⁵ The Commission reached a similar conclusion in its analysis of OptiMark Profiles, finding that "Profiles are analogous to indications of interest or CAP orders,⁸⁶ neither of which are displayed in exchanges or on Nasdaq."⁸⁷ Therefore, the inchoate trading interest of discretionary orders should not be treated as a bid or offer under the Quote Rule.⁸⁸

VIII. PCX Will Continue To Participate in the National Market System

Nasdaq also voiced concern over ArcaEx's integration into the Intermarket Trading System ("ITS") because aspects of the ArcaEx trading algorithm appeared to conflict with two basic components of the ITS Plan—the pre-opening application⁸⁹ and continuous, two-sided quotations.⁹⁰ The PCX remains supportive of the national market system and intends to continue to comply with the national market system plans once ArcaEx becomes operational. Discussions are ongoing with the relevant operating committees, among others, regarding the integration of ArcaEx into the national market system.

IX. PCX Will Maintain All Required Books and Records in the United States

The PCX represents that it will keep all books and records that it is required to maintain under the Exchange Act, including those related to ArcaEx, in the United States.

* * * * *

The PCX believes that the proposed rule change is consistent with the requirements of the Exchange Act, including Sections 6 and 11A, and the rule and regulations thereunder applicable to a national securities exchange. In particular, the PCX believes that the ArcaEx rules are designed to promote just and equitable principles of trade, remove

See, e.g., Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141, 63145 (1994).

⁸⁵ Rule 11Ac1-1(a)(4) under the Exchange Act.

⁸⁶ For a description of CAP orders, *see, e.g.,* NYSE Rules 13 and 123A.

⁸⁷ *See, e.g.,* OptiMark Release, 62 FR at 50046.

⁸⁸ This may be especially true for indications of interest expressed by those who do not constitute "members" or "responsible broker-dealers" within the meaning of the Quote Rule. *See* Order Handling Release, 61 FR at 48311, n. 248.

⁸⁹ As described in the proposed PCXE Rules (*see* Proposed PCXE Rule 7.35), ArcaEx has developed an automated opening for its order-driven market, which is designed to provide efficient price discovery, while ensuring investor protection. PCX, based on its business judgment, believes the ArcaEx opening mechanism will prove effective for its Users. In addition, PCX believes that the opening is consistent with, and fosters the goals of, the Exchange Act. In that vein, PCX also believes that ArcaEx complies with the pre-opening application of the ITS Plan.

⁹⁰ Nasdaq II Letter at 12.

⁷² Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions directly on the exchange floor. To comply with the rule's conditions, a member (1) must transmit the order from off the exchange floor; (2) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution; (3) may not be affiliated with the executing member; and (4) with respect to an account over which the member or an associated person has investment discretion, neither the member nor the associated person may retain any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule.

⁷³ *See* 1978 Release II at 18560.

⁷⁴ For a detailed analysis of how ArcaEx satisfies the requirements of the effect versus execute rule, *see* Appendix B.

⁷⁵ *See, e.g.,* Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Edith Hallahan, Associate General Counsel, Phlx, dated Mar. 24, 1999 ("VWAP Letter") (approving Phlx's VWAP Trading System); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to David E. Rosedahl, PCX, dated Nov. 30, 1998 ("OptiMark Letter") (approving the PCX Application of OptiMark); Letter regarding Chicago Match, from Brandon Becker, Director, Division of Market Regulation, SEC, to George T. Simon, Partner, Foley & Lardner, dated Nov. 30, 1994 ("Chicago Match Letter"); and Securities Exchange Act Release No. 29237 (May 31, 1991), 56 FR 24853 (May 31, 1991) (approving the New York Stock Exchange's Off-Hours Trading Facility).

⁷⁶ *See* 1979 Release at 6087, n. 35.

⁷⁷ Nasdaq II Letter at 11.

⁷⁸ Proposed PCXE Rule 7.31(h)(2).

⁷⁹ Proposed PCXE Rule 7.36.

⁸⁰ For a detailed analysis of the benefits of discretionary orders in addition to how they comply with the Quote Rule, *see* Appendix B.

⁸¹ *See* Rule 11Ac1-1 under the Securities Exchange Act.

⁸² *See* Rule 11Ac1-1(a)(4) under the Securities Exchange Act.

⁸³ PCX OptiMark Release at 50046.

⁸⁴ As the Commission has stated repeatedly, the Quote Rule is premised on the notion of a bid or offer at one specified price and one specified size.

impediments to and perfect the mechanism of a free and open market and a national market system, and, in general protect investors and the public interest, as required by Section 6(b)(5) of the Securities Exchange Act. For the foregoing reasons, the PCX requests that the Commission approve the proposed rule changes regarding ArcaEx.

If you have any questions or concerns, please feel free to call Kathryn Beck of the PCX at 415.393.7936, Brandon Becker at 202.663.6979 or the undersigned at 202.663.6855.

Sincerely,
Cherie Macauley
cc: Annette Nazareth,
Robert L.D. Colby,
Belinda Blaine,
Larry Bergman,
Caite McGuire,
Steve Williams,
Patrick Joyce,
John Roeser,
Marc McKayle,
Kathryn Beck,
Dave Rosedahl.

Appendix B—ArcaEx Operates in Compliance With Section 11(a) of the Securities Exchange Act

A. Background

Section 11(a) of the Securities Exchange Act ("Exchange Act") prohibits a member of a national securities exchange from effecting transactions on the exchange for its own account, the account of an associated person, or an account in which it or an associated person exercises investment discretion (collectively, "covered accounts"), unless an exception applies. First enacted as part of the Securities Acts Amendments of 1975,⁹¹ Section 11(a) was intended by Congress to address trading advantages enjoyed by exchange members and conflicts of interest in money management.⁹² In particular, as noted by the Securities and Exchange Commission ("SEC" or "Commission"), Congress was concerned about members benefiting in their principal transactions from special "time and place" advantages associated with floor trading—such as the ability to "execute decisions faster than public investors."⁹³

Where principal transactions contribute to the fairness and orderliness of exchange markets or do not reflect any time and place trading advantages, they are excepted from the prohibition. Among the transactions

excepted under Section 11(a)(1) are those by a dealer acting in the capacity of a market maker,⁹⁴ bona fide arbitrage or hedge transactions,⁹⁵ and transactions made to offset errors.⁹⁶ Rule 11a2-2(T) under the Exchange Act provides an exception in addition to those delineated in the statute.

Commonly referred to as the "effect versus execute" rule, Rule 11a2-2(T) permits an exchange member, subject to certain conditions, to effect transactions for covered accounts by arranging for an unaffiliated member to execute the transactions directly on the exchange floor. To comply with the rule's conditions, a member (1) must transmit the order from off the exchange floor; (2) may not participate in the execution of the transaction once it has been transmitted to the member performing the execution;⁹⁷ (3) may not be affiliated with the executing member; and (4) with respect to an account over which the member or an associated person has investment discretion, neither the member nor the associated person may retain any compensation in connection with effecting the transaction without express written consent from the person authorized to transact business for the account in accordance with the rule.

As described by the Commission, these four requirements—off-floor transmission, non-participation in order execution, execution through an unaffiliated member and non-retention of compensation for discretionary accounts—were "designed to put members and non-members on the same footing, to the extent practicable, in light of the purposes of Section 11(a)."⁹⁸ If a transaction meets the requirements of the "effect versus execute" rule, it will be deemed to be "consistent with the purpose of Section 11(a)(1) of the Act, the protection of investors, and the maintenance of fair and orderly markets."⁹⁹

In the past, the Commission and its staff have allowed exchanges to sponsor innovative trading systems in reliance on Rule 11a2-2(T), finding that such facilities, by design, do not provide any special time and place advantage to members.¹⁰⁰ In

particular, where the execution is performed by the facility itself through an automated service, it has been determined that "the member would not retain any ability to control the timing of the execution or otherwise enjoy the kind of special order-handling advantages inherent in being on an exchange floor."¹⁰¹ Rule 11a2-2(T) thus has been applied in a functional manner, taking into account the structural characteristics that distinguish the operation of an automated trading system from traditional floor activities. This approach represents the sensible conclusion by the Commission and its staff that implementation of Section 11(a) should reflect the "continuing rapid pace of economic, technological and regulatory changes in the markets."¹⁰²

B. Discussion

ArcaEx represents a new electronic trading facility of the PCXE that may be utilized by ETP Holders and their customers to effect the purchase and sale of securities.¹⁰³ As discussed in more detail below, ArcaEx will place all of its Users—both ETP Holders and non-ETP Holders—on the "same footing," as intended by Rule 11a2-2(T). Given the automated matching and execution services, no ETP Holder will enjoy any special control over the timing of execution or special order handling advantages, as all orders will be centrally processed for execution by computer, rather than being handled by a member through bids or offers made on the trading floor. Because ArcaEx's open, electronic structure is designed to prevent any ETP Holders from gaining any time and place advantages, ArcaEx satisfies the four requirements of the "effect versus execute" rule as well as the general policy objectives of Section 11(a).

1. Off-Floor Transmission

Rule 11a2-2(T) requires the orders for a covered account transaction to be transmitted from off the exchange floor. In considering the application of this requirement to a number of automated trading and electronic order-handling facilities operated by national securities exchanges, the Commission has deemed the off-floor requirement to be met if the order is transmitted from off the floor directly to the exchange floor by electronic means.¹⁰⁴ Like these other automated

Market Regulation, SEC, to George T. Simon, Partner, Foley & Lardner, dated Nov. 30, 1994 ("Chicago Match Letter"); and Securities Exchange Act Release No. 29237 (May 31, 1991), 56 FR 24853 (May 31, 1991) (approving the New York Stock Exchange's Off-Hours Trading Facility).

¹⁰¹ See 1979 Release at 6087, n. 35.

¹⁰² See *id.* at 6987.

¹⁰³ For a detailed description of how ArcaEx will operate, see Securities Exchange Act Release No. 43608 (Nov. 21, 2000). Capitalized terms not defined herein will have the meanings given them in that release.

¹⁰⁴ Among the systems considered by the Commission are (1) the Phlx's VWP Trading System (see VWP Letter); (2) the PCX Application of OptiMark (see OptiMark Letter); (3) Chicago Match (see Chicago Match Letter); (4) the Amex's Post Execution Reporting System and the Amex Switching System (see 1979 Release at n. 25); (5) ITS; (6) the Multiple Dealer Trading Facility of the

Continued

⁹¹ See Pub. L. No. 94-29, 89 Stat. 110 (June 4, 1975).

⁹² See Securities Reform Act of 1975, Report of the House Comm. on Interstate and Foreign Commerce, H.R. Rep. No. 94-123, 94th Cong., 1st Sess. (1975) ("House Report"); Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975).

⁹³ See Securities Exchange Act Release No. 14563 (Mar. 14, 1978), 43 FR 11542, 11543 (Mar. 17, 1978) ("1978 Release I"); Securities Exchange Act Release No. 14713 (Apr. 27, 1978), 43 FR 18557, 18588 (May 1, 1978) ("1978 Release II"); Securities Exchange Act Release No. 15533 (Jan. 29, 1979), 44 FR 6084, 6092 (Jan. 31, 1979) ("1979 Release"). The 1978 and 1979 Releases cite the House Report at 54-57.

⁹⁴ See Section 11(a)(1)(A), 15 U.S.C. § 78k(a)(1)(A). In addition to the application of Rule 11a2-2(T), as discussed below, ETP Holders who are registered as market makers on the Archipelago Exchange ("ArcaEx") may also take advantage of this market maker exemption from Section 11(a), at least for securities in which they make a market.

⁹⁵ See Section 11(a)(1)(D) of the Securities Exchange Act.

⁹⁶ See Section 11(a)(1)(F) of the Securities Exchange Act.

⁹⁷ The member may participate, however, in clearing and settling the transaction.

⁹⁸ See 1978 Release II at 18560.

⁹⁹ See Rule 11a2-2(T)(e) under the Securities Exchange Act.

¹⁰⁰ See, e.g., Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Edith Hallahan, Associate General Counsel, Phlx, dated Mar. 24, 1999 ("VWP Letter") (approving Phlx's VWP Trading System); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to David E. Rosedahl, PCX, dated Nov. 30, 1998 ("OptiMark Letter") (approving the PCX Application of OptiMark); Letter regarding Chicago Match, from Brandon Becker, Director, Division of

systems, orders sent to ArcaEx will be transmitted from remote terminals directly to the system by electronic means. Therefore, Users' orders electronically received by ArcaEx satisfy the off-floor transmission requirement for the purposes of the "effect versus execute" rule.¹⁰⁵

2. Non-Participation in Order Execution

The "effect versus execute" rule further provides that the exchange member and its associated person may not participate in the execution of the transaction once the order has been transmitted. This requirement originally was intended to prevent members with their own brokers on the exchange floor from using those persons to influence or guide their orders' execution.¹⁰⁶ It does not preclude members from canceling or modifying orders, or from modifying instructions for executing orders, after they have been transmitted; provided, however, that such cancellations or modifications are also transmitted from off the exchange floor.¹⁰⁷

In analyzing the application of the non-participation requirement to automated exchange facilities, the Commission specifically noted in regard to the COMEX and PACE systems that (1) the "initiating member relinquishes any ability to influence or guide the execution of its order at the time that order is transmitted into the system" and (2) "[while] the execution of the order is thereafter automatic and does not involve any independent executing member, the design of those systems insures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the floors of the Phlx or the PSE."¹⁰⁸ As a result, orders transmitted to the COMEX and PACE systems were deemed to comply with this requirement. More recently, the Commission reached the same conclusion concerning the VWAP Trading System, OptiMark and the Chicago Match, stating that a member does not retain the ability to influence or guide the execution of an order after the member submits the order to each of these systems.¹⁰⁹

As with these other trading systems, the orders submitted to ArcaEx similarly meet the non-participation requirement. Upon submission to ArcaEx, an order will enter the queue and be executed against another order in the Arca Book based on an established matching algorithm. The execution depends, not on the ETP Holder, but rather, upon what other orders are entered into ArcaEx at or around the same time as the subject order, what orders are resident in the Arca Book

and where the order is ranked based on the price-time priority ranking algorithm. Therefore, at no time following the submission of an order is an ETP Holder able to acquire control or influence over the result or timing of orders generated. That is, unlike a floor broker who currently enjoys a trading advantage inherent to being present on an exchange floor for transactions being executed on that floor, no ETP Holder may take advantage of any non-member User through use of ArcaEx. As a result, the non-participation requirement is met where ETP Holder orders are matched and executed automatically in the ArcaEx.

3. Execution Through Unaffiliated Member

Although Rule 11a2-2(T) contemplates having an order executed by an exchange member who is unaffiliated with the member initiating the order, the Commission has recognized in the past that this requirement is not applicable where automated exchange facilities are used. For example, in considering the operation of COMEX and PACE, among other systems, the Commission noted that, while there is no independent executing exchange member, the execution of an order is automatic once it has been transmitted into the systems.¹¹⁰ Because the design of these systems ensures that members do not possess any special or unique trading advantages in handling their orders after transmitting them to the exchange floors, the Commission has stated that executions obtained through these systems satisfy the independent execution requirement of Rule 11a2-2(T).¹¹¹ This principle is directly applicable to ArcaEx; the design of ArcaEx ensures that ETP Holders do not have any special or unique trading advantages in handling their orders after transmission. Accordingly, an ETP Holder effecting a transaction by utilizing ArcaEx satisfies the requirement for execution through an unaffiliated member.

4. Non-Retention of Compensation for Discretionary Accounts

Finally, the exemption in Rule 11a2-2(T) states that, in the case of a transaction effected for an account for which the initiating member exercises investment discretion, in general, the member may not retain compensation for effecting the transaction. As a prerequisite to use of ArcaEx, if an ETP Holder is to rely on Rule 11a2-2(T) for a managed account transaction, the ETP Holder must comply with the limitations on compensation as set forth in paragraph (a)(2)(iv) of the "effect versus execute" rule.

C. Conclusion

In sum, ArcaEx is designed to, and does, comply with the letter and spirit of Section 11(a) of the Exchange Act.

¹¹⁰ See 1979 Release. See also VWAP Letter, OptiMark Letter and Chicago Match Letter.

¹¹¹ *Id.*

Appendix C—ArcaEx Discretionary Orders Comply With Rule 11Ac1-1 and Foster the Goals of the Exchange Act

A. Background

In its rule filing, the PCX has proposed the use of discretionary orders on ArcaEx. A discretionary order is defined as "an order to buy or sell a stated amount of a security at a specified, undisplayed price (the 'discretionary price'), in addition to, at a specified, displayed price ('displayed price')." ¹¹² For all non-marketable discretionary orders, the discretionary order will be displayed to all Users at the displayed price. No Users will see the discretionary price of the orders. An undisplayed, discretionary price order will be afforded price priority in the Arca Book, but not time priority relative to displayed orders.¹¹³

B. Discussion

1. Discretionary Orders Comply With the Firm Quote Rule

Rule 11Ac1-1 under the Securities Exchange Act ("Exchange Act"), the so-called "Quote Rule," mandates national securities exchanges, subject to certain exceptions, to collect and disseminate "best bids" and "best offers" from a "responsible broker or dealer."¹¹⁴ ArcaEx's treatment of discretionary orders complies with the requirements of the Rule.

a. The Discretionary Price of a Discretionary Order is Not Communicated to Other Market Participants

An important attribute of a bid or offer subject to the Quote Rule is that it represents the "bid price and the offer price *communicated* by an exchange member or OTC market maker to any broker or dealer, or to any customer."¹¹⁵ Accordingly, "[i]n order to constitute a bid or offer, the underlying trading interest must have been communicated to at least one potential counterparty. Bids and offers are intended to attract other parties to deal with the person publishing the bid or offer."¹¹⁶ For example, in the Order Handling Release, the Commission deemed the entry of priced orders into an electronic communications network ("ECN") to be bids and offers where these orders were *widely disseminated*.¹¹⁷ Such priced orders are subject to the Quote Rule because, just like market maker or specialist quotations, they are "entered to elicit other buying and selling interest."¹¹⁸ Applying this logic, the Commission concluded that OptiMark Profiles were not bids or offers because only OptiMark was

¹¹² Proposed PCXE Rule 7.31(h)(2)

¹¹³ Proposed PCXE Rule 7.36.

¹¹⁴ See Rule 11Ac1-1 under the Securities Exchange Act.

¹¹⁵ See Rule 11Ac1-1(a)(4) under the Securities Exchange Act.

¹¹⁶ Securities Exchange Act Release No. 39086 (Sept. 17, 1997), 62 FR 50036, 50046 (1997) ("PCX OptiMark Release").

¹¹⁷ See Securities Exchange Act Release No. 37619A (Sept. 12, 1996), 61 FR 48290, 48313 (1996) ("Order Handling Release"). See also PCX OptiMark Release at 50046.

¹¹⁸ Order Handling Release at 48313.

CSE; (7) the PCX's Communications and Execution System ("COMEX"); and (8) the Phlx's Automated Communications and Execution System ("PACE") (see 1979 Release at nn. 19-35 and accompanying text).

¹⁰⁵ The Commission has not considered the lack of a traditional physical floor to be an impediment to the satisfaction of the off-floor requirement. See, e.g., 1979 Release (discussing the CSE's NSTS satisfaction of this requirement).

¹⁰⁶ See generally 1978 Release I.

¹⁰⁷ See *id.*

¹⁰⁸ See 1979 Release at n. 25.

¹⁰⁹ See VWAP Letter; OptiMark Letter and Chicago Match Letter.

“aware of the potential trading interest until the trade occurs.”¹¹⁹

With discretionary orders on ArcaEx, the discretionary price of a discretionary order is not communicated to any Users of the system. Only ArcaEx is aware of the full potential trading interest of these discretionary orders until trades occur. Accordingly, because ArcaEx does not publish the discretionary aspect of these discretionary orders, they should not be deemed to be a “bid or offer” within the meaning of the Quote Rule.

b. Discretionary Orders Represent a More Complex Trading Interest Than Traditional “Bids” or “Offers”

Discretionary orders allow the investor to express a more complex—and more accurate—trading interest than the single price and size of a conventional order.¹²⁰ Unlike “bids” and “offers,” discretionary orders reflect the fact that there is usually more than one price at which an investor is willing to buy or sell. Because these discretionary orders represent a qualitatively different set of information from the traditional price and size information, they are more analogous to indications of interest, than bids and offers. Therefore, like indications of interest, discretionary orders should be excluded from the requirements of the Quote Rule.¹²¹ The Commission reached a similar conclusion in its analysis of OptiMark Profiles, finding that “Profiles are analogous to indications of interest or CAP orders,¹²² neither of which are displayed in exchanges or on Nasdaq.”¹²³ Therefore, the inchoate trading interest of discretionary orders should not be treated as a bid or offer under the Quote Rule.¹²⁴

c. Inclusion of Discretionary Orders Would Impair the Existing Quote Information

Because the discretionary orders represent a more complex expression of trading preferences than traditional orders, any attempt to include them in the public quotation stream would undermine the Commission’s efforts to improve the “quality of published quotations, competition and price efficiency.”¹²⁵ The Commission has long recognized that “quotation information is of significant value to the marketplace as a whole insofar as a quotation reflects the considered judgment of a market professional as to various factors affecting the market, including the current price levels and size of buying and selling interest.”¹²⁶ Because the

discretionary orders do not represent any “current” market judgment as to a particular transaction price or size, the investing public at large would be misled and confused by its inclusion in public quotations.¹²⁷ Furthermore, the Commission has previously stated that the dissemination of contingent trading interest, like discretionary orders, “would likely be very difficult” and “could create confusion for investors.”¹²⁸

2. The Commission Has Approved the Use of Similar Orders in Other Contexts

a. Exchanges Must Be Allowed To Compete on Equal Footing With Alternative Trading Systems

In adopting Regulation ATS, the Commission expressly recognized the value of conditional orders and specifically allowed ATSs to continue using reserve size orders, negotiation features and other similar conditional orders.¹²⁹ Specifically, under Rule 301(b)(3), if a portion of a subscriber’s order is not displayed to others, that undisplayed portion is not subject to the public display requirements in Rule 301(b)(3).¹³⁰

Because a fundamental goal of the national market system is to “achieve a market characterized by * * * fair competition,”¹³¹ the Commission previously has recognized the importance of facilitating “opportunit[ies] for registered exchanges to better compete with alternative trading systems.”¹³² Therefore, the Commission should not prohibit a registered exchange’s use of these order types when it allows an ATS to use them.¹³³ Such an unnecessary prohibition creates an unlevel playing field between exchanges and ATSs—two trading venues which are considered true competitors in today’s markets¹³⁴—in opposition to the national market system goals.¹³⁵

b. ArcaEx’s Discretionary Orders Electronically Perform the Same Function as Provided Manually in Today’s Trading Environment

In a traditional floor trading environment, broker-dealers enjoy the discretion to “work”

an order to ensure that the customer receives the best price for the trade. This special handling permits the broker-dealer to respond to the ever-changing state of the market. For example, a broker may represent a customer’s trading interest at one price, given the state of the current market, but be prepared to offer the trade at a different price if the market moves. To provide an effective trading platform, ArcaEx must be permitted to provide an electronic mechanism which replicates some of these value-added activities of market intermediaries. Therefore, ArcaEx has designed the discretionary orders. This order type allows an aspect of the order to respond to the dynamic trading environment without the need for manual order handling.¹³⁶

3. Discretionary Orders Benefit Investors in an Electronic Environment

a. Discretionary Orders Enhance Liquidity

The Commission has emphasized that one of its goals as a regulator is to provide “the deepest, most liquid markets possible” and to “minimize short-term price volatility.”¹³⁷ Discretionary orders can help the Commission reach this goal. By providing investors with greater flexibility in the handling of their orders, the discretionary orders will encourage greater investor participation on the PCX, which, in turn, will increase the depth and liquidity of the securities markets.¹³⁸ For example, the discretionary orders allow a certain amount of anonymity for a trade—something which may be very attractive to various segments of the market which would otherwise be disinclined to trade on ArcaEx. Therefore, the introduction of the discretionary order is likely to attract new market participants, both retail and institutional, thereby enhancing liquidity through increased order flow to ArcaEx.

b. Discretionary Orders Facilitate Investor Protection

In the past, the Commission has rejected claims that the use of conditional order types in electronic trading environments create a hidden market to the detriment of investors.¹³⁹ The Commission has concluded that “when orders are not displayed to

¹³⁶ The use of discretionary orders will help to further the national market system goal of fostering “an opportunity for investors’ orders to be executed without the participation of a dealer.” See Section 11A(a)(1)(C)(v) of the Securities Exchange Act. See also PCX OptiMark Release at 50046 (approving OptiMark, in part, because it “would increase the ability of investors’ orders to interact directly with other investor orders on the PCX”).

¹³⁷ Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406, 48407 (Aug. 8, 2000) (“Disclosure of Order Routing and Execution Practices Release”).

¹³⁸ See, e.g., Securities Exchange Act Release No. 42344 (Jan 14, 2000), 65 FR 3987, 3995 (Jan. 25, 2000) (“Increased participation in NNMSS [as a result of the attractiveness of reserve orders for large investors] should enhance the depth and liquidity of the market for NNM securities, to the benefit of all market participants”).

¹³⁹ See, e.g., ATS Release at 70867; PCXx OptiMark Release at 50046 (“contrary to the NYSE’s assertion, the [PCX] is not operating a hidden market in violation of the Firm Quote Rule”).

¹¹⁹ PCX OptiMark Release at 50046.

¹²⁰ As the Commission has stated repeatedly, the Quote Rule is premised on the notion of a bid or offer at one specified price and one specified size. See, e.g., Securities Exchange Act Release No. 35030 (Nov. 30, 1994), 59 FR 63141, 63145 (1994).

¹²¹ Rule 11Ac1-1(a)(4) under the Securities Exchange Act.

¹²² For a description of CAP orders, see, e.g., NYSE Rules 13 and 123A.

¹²³ See, e.g., OptiMark Release at 50046.

¹²⁴ This may be especially true for indications of interest expressed by those who do not constitute “members” or “responsible broker-dealers” within the meaning of the Quote Rule. See Order Handling Release at 48311, n. 248.

¹²⁵ See Order Handling Release at 48290.

¹²⁶ See Announcement of Written Requests Sent to Registered National Securities Exchanges

concerning Availability of Quotation Information, Securities Exchange Act Release No. 11288, 40 FR 15015 (1975).

¹²⁷ See OptiMark Release at 50046.

¹²⁸ *Id.*

¹²⁹ See Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844, 70866 (Dec. 22, 1998) (“ATS Release”).

¹³⁰ See Rule 301(b)(3) under the Exchange Act (“An [ATS] shall comply with the requirements set forth in paragraph (b)(3)(ii) of this section, with respect to any covered security in which the [ATS]: (A) displays subscriber orders to any person (other than [ATS] employees”).

¹³¹ S. Rep. No. 75, 94th Cong., 1st Sess. 8 (1975) at 101.

¹³² See ATS Release at 70844.

¹³³ See NNMSS Release at 3995 (reserve orders “allow market makers quoting in Nasdaq to compete more effectively with alternative trading systems that provide a reserve size feature”).

¹³⁴ In fact, ATS meets the definition of an exchange, but need not register as such, provided it complies with Regulation ATS. See Rule 3a1-1(a)(2) under the Exchange Act.

¹³⁵ See generally ATS Release.

anyone, the Commission's concerns about a two-tiered market—where some market participants have information others do not—are absent.”¹⁴⁰

ArcaEx's discretionary orders will not provide any market participant with an unfair trading advantage.¹⁴¹ All Users will see the same orders ranked in the Arca Book, i.e., ArcaEx will display to all User those orders which are displayed in the Limit Order Process of the Arca Book, but not the working orders in the Working Order Process.¹⁴² No Users will have special access to trading interest that is not available to others on ArcaEx. All Users have the equivalent opportunity to receive fills based on both displayed and undisplayed orders. Furthermore, no Users will be able to control or influence the trades resulting from conditional trading interest; the trades will only be executed pursuant to an established algorithm.¹⁴³ Therefore, discretionary orders fail to hurt investors in any way; they only provide benefits to the marketplace, as discussed in detail above.

C. Conclusion

Discretionary orders comply with Rule 11Ac1-1. Moreover, not only do such orders not present any potential for investor harm, they affirmatively will benefit both investor and market liquidity.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44237; File No. SR-PHLX-2001-43]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Philadelphia Stock Exchange, Inc. Adding QQQ Options to the Exchange's List of the Top 120 Equity Options

April 30, 2001.

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 March 30, 2001, the Philadelphia Stock Exchange, Inc. (“Phlx”) filed with the Securities and Exchange Commission the proposed rule change as described in Items I, II,

and III below, which Items the Phlx has prepared. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Phlx proposes to revise its list of the Top 120 Options³ by adding options on Units of Beneficial Interest in the Nasdaq-100 Trust, Series 1, which are widely known as and traded under the symbol “QQQ”. Options on the QQQ index will be added to the Phlx's list of the Top 120 Options effective April 2, 2001, and will include trades that settle on that date.

All of the options on the Phlx's list of Top 120 Options are included in the Phlx's payment for order flow program, in which a marketing fee (currently \$1.00) is imposed on the transactions of specialists and ROTs, which the specialists may use to attract order flow to Phlx. QQQ options will be included in the marketing fee program once they are added to the list of Top 120 Options. The inclusion of QQQ options on the list means that there will be 121 Options on the Phlx's list of the Top 120 options through June 30, 2001, when the current measuring period ends.

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

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Phlx has prepared summaries, set forth in Sections A, B, and C below, or 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 add QQQ options to the Phlx's list of the Top 120 Options. The list of the Top 120 Options identifies the 120 most actively traded equity options as measured by their trading volume on all U.S. options markets. The list of Top

120 Options is recalculated every six months, with the measuring periods running from January 1 through June 30 and from June 1 through November 30. The Phlx assembled its current list of Top 120 Options using data that the Options Clearing Corporation gathered during the period from June 1, 2000 through November 30, 2000.

The Phlx currently imposes a \$1.00 per contract fee on transactions of Phlx specialists and Registered Options Traders (“ROT”) in the Top 120 Options, with some exceptions.⁴ Under the program, Phlx specialists may use the proceeds raised from the marketing fee to attract order flow to the Phlx. Because options on the QQQ index are now traded on the Phlx,⁵ the Phlx is proposing to add QQQ options to its list of the Top 120 Options during the current measuring period. Accordingly, from April 2, 2001, the effective date of this proposal, through June 30, 2001, the end of the current measuring period, there will be a total of 121 options on the Phlx's list of the Top 120 Options.

2. Statutory Basis

The inclusion of QQQ options on the Phlx's list of the Top 120 Options would bring QQQ options into the Phlx's payment for order flow program. The Phlx believes that the QQQ specialist unit and the ROTs who pay the \$1.00 marketing fee should receive the benefits of increase order flow, and that the proposed rule change would equitably allocate reasonable fees among the Phlx's members. Accordingly, the Phlx—believes that the proposal is consistent with Section 6(b) of the Act,⁶ and in particular furthers the objectives of Sections 6(b)(4) and 6(b)(5) of the Act.⁷ Moreover, the Phlx believes that the inclusion of QQQ options in its list of Top 120 Options, and the

⁴ The transactions in Top 120 Options that are currently excepted from the \$1.00 fee are transactions between: (1) A specialist and an ROT; (2) an ROT and an ROT; (3) a specialist and a firm; (4) an ROT and a firm; (5) a specialist and a broker-dealer; and (6) and ROT and a broker-dealer. See Securities Exchange Act Release Nos. 43177 (Aug. 18, 2000), 65 FR 51889 (Aug. 25, 2000) (SR-PHLX-00-77); 43480 (Oct. 25, 2000), 65 FR 66275 (Nov. 3, 2000) (SR-PHLX-00-86 and SR-PHLX-00-87); and 43481 (Oct. 25, 2000), 65 FR 66277 (Nov. 3, 2000) (SR-PHLX-00-88 and SR-PHLX-00-89).

⁵ See Securities Exchange Act Release Nos. 43921 (February 2, 2000), 66 FR 9739 (Feb. 9, 2001) (SR-PHLX-00-107) (amending Phlx rules to create listing criteria and trading rules to allow the Phlx to list QQQ options); 44054 (Mar. 8, 2001), 66 FR 15314 (Mar. 16, 2001) (SR-PHLX-01-31) (increasing the automatic execution guarantee for QQQ options to 100 contracts); and 44055 (March 8, 2001), 66 FR 15310 (Mar. 16, 2001) (SR-PHLX-01-32) (amending Phlx rules to create a one-point strike price interval for QQQ options and establishing the hours of trading for QQQ options).

⁶ 15 U.S.C. 78f(b).

⁷ 15 U.S.C. 78f(b)(4) and (5).

¹⁴⁰ See ATS Release at 70867.

¹⁴¹ See, e.g., PCX OptiMark Release at 50046 (“The failure to disseminate Profile does not provide any other market participant with an unfair market advantage as a result of seeing the trading interest that is not shown to others. Any User only knows its own Profile; it has no special access to other Users' Profiles. Moreover, Users have no control or influence in determining the outcome of a match, other than through the construction of their own Profiles.”)

¹⁴² See Proposed PCXE Rule 7.36.

¹⁴³ See Proposed PCXE Rule 7.37.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Phlx defines a Top 120 Option as one of the 120 most actively traded equity options nationwide during a six-month measuring period. The Phlx revises its list of the Top 120 Options every six months using data that the Options Clearing Corporation provides.