limits its purview to transactions arising out of the use or operation of Nasdaq execution or communication systems and explicitly requires that the parties to a reviewable transaction be readily identifiable by Nasdaq through its systems. The Commission believes that the amended rule better reflects Nasdaq's interpretation of the scope of its rule. Nasdaq has represented that in the past it has declined to adjudicate petitions on the grounds that the transaction would be more appropriately reviewed by the market center on which it was executed. Therefore, the Commission believes that the proposed rule change clarifies the application and operation of the rule for market participants.

Nasdaq also proposes to amend NASD rule 11890 to state that Nasdaq's authority to review transactions based upon its own motion may be exercised in the event of extraordinary market conditions or other circumstances in which the nullification or modification of transactions may be necessary for the maintenance of a fair and orderly market or the protection of investors and the public interest. The Commission believes that the proposal clarifies Nasdaq's authority to nullify or modify transactions on its own motion and provides Nasdaq with the flexibility to address a variety of extraordinary market conditions expeditiously. The Commission notes that Nasdaq expects to assert its authority primarily in circumstances where the disruption or malfunction of a system resulted in the execution of trades with obvious errors, such as a price substantially unrelated to the inside market. Nasdaq has also represented that it will not attempt to break or modify trades entered into through, or reported to, a UTP exchange. Nasdaq will endeavor to coordinate its actions with other market centers to achieve consistent treatment of trades outside Nasdaq's jurisdiction.

Regarding the review of Nasdaq determinations by the MORC, Nasdaq proposes that an officer empowered to review transactions on Nasdaq's own motion (*i.e.*, the President or an Executive Vice President) may determine that the number of transactions affected by a decision to break or modify trades on Nasdaq's own motion is such that the decision must be accorded immediate finality in order to maintain a fair and orderly market and to protect investors and the public interest. The Commission believes that Nasdaq's proposal is reasonable and that the market may be well served by the finality it provides. Furthermore, Nasdaq has represented, and the Commission expects, that Nasdaq would use this authority only on rare occasions. For example, Nasdaq believes that there may be circumstances in which review by the MORC of a large number of trades would be impractical and could expose market participants to unacceptable levels of risk.[8]

Finally, Nasdaq proposes to describe in greater detail the parameters for communications between Nasdaq and market participants. The Commission believes that the proposal may clarify procedural aspects of the process of reviewing transactions and therefore promote the fair and efficient resolution of disputes.

IV. Conclusion

For the reasons discussed above, the Commission finds that the proposal, as amended, is consistent with the Act and the rules and regulations thereunder. It is therefore ordered, pursuant to section 19(b)(2) of the Act,[9] that the proposed rule change (SR–NASD–2002–127), as amended, be and hereby is approved.

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

Margaret H. McFarland,

Deputy Secretary.

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[8] For example, Nasdaq believes that if an erroneously priced order or quote causes a large number of transactions to occur at prices far in excess of a security's true value and if a decision is made to break all of the affected trades, some sellers may appeal the decision to break the trades. If a market participant is a party to trades on both sides of the market, and some remain broken while others are appealed and reinstated, it will suffer losses that arise solely from the inconsistent treatment of its trades.

[9] 15 U.S.C. 78s(b)(2).

[10] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–47223; File No. SR–PCX–2002–75]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Pacific Exchange, Inc., Through Its Subsidiary PCX Equities, Inc., Relating to New Order Types and To Amend PCXE Rule 7.37

January 21, 2003.

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 December 9, 2002, the Pacific Exchange, Inc. (''PCX'' or ''Exchange''), through its subsidiary, PCX Equities, Inc. (''PCXE''), filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in items I, II, and III below, which items have been prepared by the PCX. On January 15, 2003, the Exchange filed Amendment No. 1 to the proposed rule change.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The PCX, through its wholly owned subsidiary, PCXE, proposes to amend its rules governing the Archipelago Exchange, the equities trading facility of PCXE, by: (1) Adopting several new order types to accommodate the trading of securities listed on the Nasdaq Stock Market, Inc., on an unlisted trading privileges (''UTP'') basis; (2) amending PCXE rule 7.37 to provide for a limited exemption from the trade-through restrictions for some of these new order types; (3) amending certain provisions of the Working Order Process to reflect the unique operational requirements of two proposed order types; and (4) making several minor technical rule changes to conform to the Nasdaq UTP Plan, which extends UTP to Nasdaq SmallCap securities. The text of the proposed rule change follows:

Additions are *italicized*; deletions are in [brackets].

PCX Equities, Inc.

Rule 1 Definitions

Rule 1.1(a)–(z)—No change.

Nasdaq[/NM] Security

(aa) The term ''Nasdaq[/NM] Security'' shall mean any security (i) designated as *an eligible* [national market system] security pursuant to the *''Nasdaq Unlisted Trading Privileges Plan'', as amended*, [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.

Rule 1.1 (bb)–(hh)—No change.

OTC/UTP Plan

(ii) The term ''OTC/UTP Plan'' shall mean the Nasdaq *Unlisted Trading*

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

[2] 17 CFR 240.19b–4.

[3] In Amendment No. 1, the Exchange submitted a new form 19b–4, which replaced the original filing in its entirety.

Privileges [National Market/Unlisted Trading System/Unlisted Trading Privileges] Plan, as from time to time amended according to its provisions.

OTC/UTP *Listing* [Primary] Market

(jj) The term ''OTC/UTP *Listing* [Primary] Market'' for a Nasdaq[/NM] Security means *the OTC/UTP Participant's Market on which the Nasdaq Security is listed. If the Nasdaq Security is dually listed, OTC/UTP Listing Market shall mean the OTC/UTP Participant's Market on which the Nasdaq Security is listed that also has the highest number of the average of the reported transactions and reported share volume for the preceding 12-month period. The OTC/UTP Listing Market for dually-listed Nasdaq Securities shall be determined at the beginning of each calendar quarter.* [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 *Listing* [Primary] Market for the purpose of dissemination of material news.

* * * * *

Rule 7 Equities Trading

Trading in Nasdaq[/NM] Securities

Rule 7.18(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)—No change.

(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)—No change.

(c) OTC/UTP Regulatory Halts. Whenever, in the exercise of its regulatory function, the OTC/UTP *Listing* [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 *Listing* [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, reopen trading at that time, notwithstanding notification from the OTC/UTP *Listing* [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.

* * * * *

Orders and Modifiers

Rule 7.31(a)—(c)—No change.

(d) Inside Limit Order. A Limit Order, which, if routed away pursuant to rule 7.37(d), will be routed to the market participant with the best displayed price. Any unfilled portion of the order will not be routed to the next best price level until all quotes at the current best bid or offer are exhausted. If the order is no longer marketable it will be ranked in the Arca Book pursuant to rule 7.36. [Reserved.]

(e) Immediate-or-Cancel Order. A market or limit order that is to be executed in whole or in part as soon as such order is received, and the portion not so executed is to be treated as canceled. An immediate-or-cancel order for Trade-Through Exempt Securities (as defined in rule 7.37) will be permitted to trade at a price no more than three cents ($0.03) away from the NBBO displayed in the Consolidated Quote. *The NBBO price protection provision set forth in rule 7.37 will not apply to immediate-or-cancel orders in Nasdaq securities.*

(f)—(g)—No change.

(h) Working Order. Any order with a conditional or undisplayed price and/or size designated as a ''Working Order'' by the Corporation, including, without limitation:

(1)—No change.

(2) Discretionary Order. 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.'')

(A) Passive Discretionary Order. A Discretionary Order may be designated as a Passive Discretionary Order and such order will be routed pursuant to rule 7.37(d) only if the displayed price is marketable against an away market participant.

(i) For Passive Discretionary Orders in exchange-listed securities, if the discretionary price is marketable, such order will only interact with trading interest in the Arca Book pursuant to rule 7.37(b)(2) and will not be routed away. A Passive Discretionary Order for ITS Trade-Through Exempt Securities will be permitted to trade at a price no more than three cents ($0.03) away from the NBBO displayed in the Consolidated Quote.

(ii) For Passive Discretionary Orders in Nasdaq securities, if the discretionary price can be matched against orders in the Arca Book, such order will intereact with trading interest in the Arca Book pursuant to 7.37(b)(2). The NBBO price protection provision set forth in rule 7.37 will not apply to Passive Discretionary Orders in Nasdaq securities.

(B) Discretion Limit Order. A Discretionary Order may be designated as a Discretion Limit Order for Nasdaq securities only. If the discretionary price of a Discretion Limit Order can be matched against trading interest in the Arca Book, then such order will be executed at the discretionary price or better. If the discretionary price of a Discretion Limit Order can be matched against an away market participant, then such order will be routed pursuant to rule 7.37(d) but only if the displayed share size of the Discretion Limit Order is equal to or less than the displayed share size of the away market participant. The NBBO price protection provision set forth in rule 7.37 will not apply to Discretion Limit Orders in Nasdaq securities.

(3) Reserve Order. A limit order with a portion of the size displayed and with a reserve portion of the size (''reserve size'') that is not displayed on the Corporation.

(A) Sweep Reserve Order. A Reserve Order may be designated as a Sweep Reserve Order. Based upon a User's instruction, if the displayed price of a Sweep Reserve Order is marketable

against an away market participant(s), then such order will be routed (i) serially as component orders, such that each component corresponds to the displayed price, or (ii) only once in its entirety, including both the displayed and reserve portions.

(B) Random Reserve Order. A Reserve Order designated as a Random Reserve Order will have a random reserve value which, as a range of round lots, will vary the displayed size of the Reserve Order. A random reserve value set to zero will permit the displayed size of the Reserve Order to vary to within 20% of the original specified displayed size.

(i)—(u)—No change.

(v) NOW Order. A Limited Price Order that is to be executed in whole or in part on the Corporation, and the portion not so executed shall be routed pursuant to rule 7.37(d) only to one or more NOW Recipients for immediate execution as soon as the order is received by the NOW Recipient. Any portion not immediately executed by the NOW Recipient shall be cancelled. If a NOW Order is not marketable when it is submitted to the Corporation, it shall be cancelled. NOW Orders may not be Directed Orders. NOW Orders for *ITS* Trade-Through Exempt Securities (as defined in rule 7.37) may be routed and executed at a price that is no more than three cents ($0.03) away from the NBBO displayed in the Consolidated Quote. *The NBBO price protection provision set forth in rule 7.37 will not apply to NOW Orders in Nasdaq securities.*

(w) PNP Order (Post No Preference). 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 Order that would lock or cross the NBBO. PNP Orders for Trade-Through Exempt Securities (as defined in rule 7.37) will not be canceled at the time of order entry if such orders would lock or cross the NBBO. PNP Orders in *ITS* Trade-Through Exempt Securities may be executed at a price no more than three cents ($0.03) away from the NBBO displayed in the Consolidated Quote. *The NBBO price protection provision set forth in Rule 7.37 will not apply to PNP Orders in Nasdaq securities.*

(x)—(z)—No change.

(aa)—(bb)—Reserved.

(cc) Pegged Order. A limit order to buy or sell a stated amount of a security at a display price set to track the current bid or ask of the NBBO in an amount specified by the User. The associated price of each Pegged Order that is updated will be assigned a new entry time with priority in accordance with rule 7.36(a). A Pegged Order may be designated as a Reserve Order or Discretionary Order.

* * * * *

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 away markets at the NBBO, where applicable (however, a User may submit a NOW Order or Primary Only Order that may be routed to an away market without consideration of the NBBO). This rule will not apply to *designated order types including IOC, NOW, PNP, Passive Discretionary, Discretion Limit (except for exchange-listed securities), IOC Cross and PNP Cross orders in Nasdaq securities or* securities that are subject to an exemption from the Commission under SEC rule 11Aa3–2(f) to the trade-through provisions of the *ITS* Plan (''*ITS* Trade-Through Exempt Securities''). Orders in *ITS* Trade-Through Exempt Securities [designated as IOC, NOW and PNP orders] will be effected at a price no more than three cents ($0.03) away from the best bid and offer quoted in CQS.

(a)—No change.

(b)(1)—No change.

(2) Step 3: Working Order Process.

(A) An incoming marketable order shall be matched for execution against orders in the Working Order Process in the following manner:

(i)—(iii)—No change.

(iv) *Determination of a Passive Discretionary Order's Execution Price.*

(a) For Nasdaq Securities, if the BBO is outside the NBBO and a Passive Discretionary Order(s) within the Working Order Process has a discretionary price worse than the NBBO, then the incoming order will execute against such Passive Discretionary Order(s) at the price of the incoming order or the displayed price of the Discretionary Order(s), whichever is better.

(b) For Nasdaq Securities, if the BBO is outside the NBBO and a Passive Discretionary Order(s) within the Working Order Process has a discretionary price equal to or better than the NBBO, then the incoming order will execute against such Passive Discretionary Order(s) pursuant to subsection (2)(A)(ii) above.

(c) For ITS Trade-Through Exempt Securities (as defined in Rule 7.37), if the BBO is outside the NBBO and a Passive Discretionary Order(s) within the Working Order Process has a discretionary price worse than the NBBO by three cents ($0.03) or less, the incoming order will execute against such Passive Discretionary Order(s) at the price of the incoming order or the displayed price of the Discretionary Orders(s), whichever is better.

(v)—No change.

(B) An incoming order that is not marketable shall be matched for execution against orders in the Working Order Process in the following manner:

(i)—(ii)—No change.

(C) *With the exception of Passive Discretionary Orders and Discretion Limit Orders,* [I]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.

(i) Passive Discretionary Orders will be routed away only if the displayed price is marketable against an away market participant.

(ii) Discretion Limit Orders will be routed away only if the displayed share size of the Discretion Limit Order is equal to or less than the displayed share size of the away market participant.

(c)—(e)—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, Nasdaq 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. PCX has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

Purpose

1. *Proposed New Order Types*

As part of its ongoing preparation for the trading of Nasdaq securities on the Archipelago Exchange (''ArcaEx'') facility pursuant to UTP,[4] PCX proposes to adopt several new order types, which are currently in use on the Archipelago electronic communication network (''ECN'').[5] These proposed order types will apply to both Nasdaq and listed securities traded on ArcaEx.[6] The Exchange believes that these order types will provide ETP Holders [7] and Sponsored Participants [8] (collectively ''Users'') greater flexibility in determining how their orders will be executed. The proposed order types are discussed below.

a. *Inside Limit Order*

An Inside Limit Order is a limit order that is to be executed in whole or in part on ArcaEx, and the portion not so executed would be routed pursuant to rule 7.37(d) to the market participant [9] with the best displayed price. Any unfilled portion of the order would not be routed to the next best price level until all quotes at the current best bid or offer are exhausted. For example, after having proceeded through the four order execution processes of the ArcaEx Book,[10] there remains an unexecuted portion of an Inside Limit Order to buy at a price of 12.50. ArcaEx would route the order to the away market participant with the best displayed offer. Suppose the best displayed offer by other market participants is Market A at 12.45, Market B at 12.46, Market C at 12.47, and Market D at 12.50. The Inside Limit Order would be routed first to Market A at 12.45. The balance of the Inside Limit Order would not be routed to the next price level (*i.e.*, Market B at 12.46) until the current offer is exhausted. Each successive number of shares remaining (if any) would be routed at the next price level in the same manner. If the Inside Limit Order is no longer marketable it would be ranked in the Arca Book pursuant to rule 7.36.

b. *Discretionary Orders*

Currently, a User can submit a Discretionary Order, which is an order to buy or sell a stated amount of a security at a specified, undisplayed price (the ''discretionary price''), as well as at a specified, displayed price. The undisplayed prices of a Discretionary Order are represented in the Working Order Process [11] and can be matched with orders on the other side of the market under prescribed conditions. Since the Discretionary Order type allows a User to represent a single order at multiple price points, investors are able to express their trading interest more accurately than is possible with traditional order types. The Exchange is proposing to adopt two new variations of the Discretionary Order called a ''Passive Discretionary Order'' and a ''Discretion Limit Order,'' which would provide Users with more flexibility when such orders are routed to away market participants. A summary of these proposed order types is discussed below.

i. *Passive Discretionary*

The Exchange proposes to add PCXE rule 7.31(h)(2)(A) to define a Passive Discretionary Order. A Discretionary Order may be designated as a Passive Discretionary Order and such order would be routed pursuant to rule 7.37(d) only if the displayed price is marketable against an away market participant. If the discretionary price of a Passive Discretionary Order were marketable, such order would only interact with trading interest in the ArcaEx Book pursuant to rule 7.37(b)(2) and would not be routed away. Under the proposal, the Passive Discretionary order type will be available for exchange-listed and Nasdaq securities. For Passive Discretionary Orders in exchange-listed securities, if the discretionary price is marketable, such order will only interact with trading interest in the ArcaEx Book pursuant to rule 7.37(b)(2) and will not be routed away. A Passive Discretionary Order for ITS Trade-Through Exempt Securities (as defined in rule 7.37) will be permitted to trade at a price no more than three cents ($0.03) away from the NBBO displayed in the Consolidated Quote. For Passive Discretionary Orders in Nasdaq securities, if the discretionary price can be matched against orders in the ArcaEx Book, then such order will interact with trading interest in the ArcaEx Book pursuant to 7.37(b)(2). The NBBO price protection provision set forth in rule 7.37 will not apply to Passive Discretionary Orders in Nasdaq securities.

To illustrate how this order type is processed by the ArcaEx trading system, suppose that a User submits a Passive Discretionary Order to buy 1000 shares at 12.48 (discretion to 12.50). After first attempting to match the order with available trading interest in the ArcaEx Book (up to a price of 12.50), ArcaEx would route the order to an away market participant, but only if the offer published by the market participant is equal to or less than the displayed price of 12.48. In the event that a Passive Discretionary Order routed from ArcaEx to another market participant is not executed in its entirety at the other market participant's quote, ArcaEx would attempt to match the residual against trading interest in the ArcaEx Book pursuant to rule 7.37. Finally, if the Passive Discretionary Order is no longer marketable it would be ranked in the ArcaEx Book pursuant to rule 7.36.

ii. *Discretion Limit*

The Exchange also proposes to add PCXE rule 7.31(h)(2)(B) to define a Discretion Limit Order. A Discretionary Order may be designated as a Discretion Limit Order for Nasdaq securities only. If the discretionary price of a Discretion Limit Order could be matched against trading interest in the ArcaEx Book, then such order would be executed at the discretionary price or better against the displayed share size of available trading interest in the ArcaEx Book, regardless of size. If the discretionary price of a Discretion Limit Order could be matched against an away market participant, then such order would be routed pursuant to rule 7.37(d) but only if the displayed share size of the Discretion Limit Order is equal to or less than the displayed share size of the away market participant. As discussed in more detail in section 2 below, the Exchange is proposing that the NBBO price protection provision set forth in rule 7.37 will not apply to Discretion Limit Orders.

c. *Reserve Orders*

Under current PCXE rule 7.31(h)(3), a Reserve Order is a limit order with a portion of the size displayed and with a reserve portion of the size (''reserve size'') that is not displayed on the

[4] The Nasdaq UTP Plan was initially approved in 1990. *See* Securities Exchange Act Release No. 28146 (June 26, 1990), 55 FR 27919 (July 6, 1990) (S7–24–89). It has subsequently been amended on several occasions to, among other things, admit new Participants. *See also* Securities Exchange Act Release No. 46381 (August 19, 2002), 67 FR 54687 (August 23, 2002) (S7–24–89) (Order approving most recent amendments to Nasdaq UTP Plan, the 13th Amendment).

[5] The broker-dealer commonly referred to as the Archipelago ECN is Archipelago Securities, a wholly owned subsidiary of Archipelago Holdings LLC and a member of the NASD. The ECN function will cease to operate as such once all the Nasdaq securities have been transferred to ArcaEx.

[6] The proposed Discretion Limit order type will apply to Nasdaq securities only. *See* proposed PCXE rule 7.31(h)(2)(B).

[7] *See* PCXE rule 1.1(n).

[8] A ''Sponsored Participant'' means ''a person which has entered into a sponsorship arrangement with a Sponsoring ETP Holder pursuant to [PCXE] rule 7.29.'' *See* PCXE rule 1.1(tt).

[9] *See* PCXE rule 1.1(w) (definition of ''market participant'').

[10] ArcaEx maintains an electronic file of orders, called the ArcaEx Book, through which orders are displayed and matched. The ArcaEx Book is divided into four components, called processes—the Directed Order Process, the Display Order Process, the Working Order Process, and the Tracking Order Process. *See* PCXE rule 7.37 for a detailed description of these order execution processes.

[11] The Working Order Process is the third step in the ArcaEx execution algorithm. Working Orders are defined to include any order with a conditional or undisplayed price and/or size, including All-or-None, Discretionary, and Reserve Orders. *See* PCXE rule 7.37(b)(2) (description of ''Working Order Process'').

ArcaEx Book. For example, a User could submit a Reserve Order to buy 5000 shares of XYZ security at 20 with a request that 1000 shares are displayed and 4000 shares, as the reserve size, are not displayed. With this filing, the Exchange is proposing to adopt two new variations of the Reserve Order called a ''Sweep Reserve Order'' and a ''Random Reserve Order.'' These proposed order types would be ranked and maintained in the Display Order Process [12] and/or Working Order Process of the ArcaEx Book according to price-time priority and would be processed for internal matches in a manner no different than a standard Reserve Order pursuant to PCXE rule 7.37(b)(2). The proposed rule change regarding Sweep Reserve Orders merely provides a clarification as to the manner in which such orders would be treated through ArcaEx's trading system when the routing of these orders to other market participants is required. In the case of a Random Reserve Order, the proposed rule change would allow a User to define the original display quantity and a random reserve value that would be used to determine the displayed quantity within a defined range each time it is replenished. These proposed order types are discussed separately below.

i. *Sweep Reserve Order*

Under proposed PCXE rule 7.31(h)(3)(A), a Reserve Order may be designated as a Sweep Reserve Order. Based upon a User's instruction, if the displayed price of a Sweep Reserve Order is marketable against an away market participant(s), then such order will be routed (i) serially as component orders, such that each component corresponds to the displayed price, or (ii) only once in its entirety, including both the displayed and reserve portions. The Exchange believes that this rule change codifies current order routing methodology, and that the proposed Sweep Reserve Order type is clearly implied in current PCXE rule 7.37(d)(2)(A)(ii).

ii. *Random Reserve Order*

The Exchange proposes to add PCXE rule 7.31(h)(3)(B) to define a Random Reserve Order. Under the rule proposal, a User could define not only a display and reserve quantity, but also a random reserve delta that could be used to determine the displayed quantity within a defined range each time it is replenished in a random amount (rounded to the nearest round lot). Users are required to display at least 100 shares for all Reserve Orders including Random Reserve Orders. The following examples illustrate the use of the Random Reserve Order.

Suppose a User entered a Random Reserve Order for 10,000 shares with a display quantity of 2000 shares and a random reserve delta of 200 shares. This order would randomly display orders at 1800 (200 shares less than the original display quantity), 1900 (100 shares less than the original display quantity), 2000, 2100 (100 shares more than the original display quantity) or 2200 shares (200 shares more than the original display quantity) each time the displayed portion of the order is replenished. If the User does not specify the random reserve delta or the random reserve delta is set to zero, the ArcaEx system would assign the displayed size of the Reserve Order to vary to within 20% of the original specified displayed size. In the example above, the displayed amount would fall within a 400-share range (*i.e.*, 20% of 2000 shares is 400 shares).

Should a User enter a Random Reserve Order with a display amount of 500 shares or less and a random reserve delta that is unspecified or set to zero, the order would be handled as a regular Reserve Order. Suppose a User entered a Random Reserve Order with a display amount of 100 shares, a reserve amount of 1,000 shares, and a random reserve of zero. The ArcaEx system would treat this order as a regular Reserve Order and the display quantity will be refreshed at the original displayed size (100 shares), *i.e.*, the ArcaEx system would not vary the display quantity for this order.

d. *Pegged Orders*

The Exchange is proposing to modify the ArcaEx trading system to accept Pegged Orders. A Pegged Order is a limit order to buy or sell a stated amount of a security at a display price set to track the current bid or ask of the NBBO in an amount specified by the User.[13] The tracking of the relevant Consolidated Quote information for Pegged Orders would occur on a real-time basis in a dynamic fashion. The associated price of each Pegged Order that is updated would be assigned a new entry time with priority in accordance with rule 7.36(a). A Pegged Order may be designated as a Reserve Order or Discretionary Order and would be subject to the applicable order execution rules. Finally, Pegged Orders are only eligible during the Core Session.

2. *Amendment to PCXE Rule 7.37*

The Exchange's current rules governing the order execution processes for orders in the ArcaEx Book are set forth in PCXE rule 7.37. Presently, rule 7.37 provides, in part, that for an execution to occur in any Order Process, the price must be equal to or better than the NBBO. The requirements of this rule do not apply to orders designated as Immediate-or-Cancel (''IOC''), NOW and Post No Preference (''PNP'') in certain exchange-traded funds (''ETFs'') that are subject to the Commission's order granting a *de minimis* exemption from the trade-through restrictions of the Intermarket Trading System (''ITS'') Plan; provided, however, that any resulting executions will be at a price no more than three cents ($0.03) away from the NBBO displayed in the Consolidated Quote.[14] The current proposal would also broaden this exception to include Passive Discretionary, IOC Cross and PNP Cross order types.[15] The definition for a Passive Discretionary Order includes a provision clarifying the application of the Commission's *de minimis* exemption order. The Exchange is also proposing that the aforementioned NBBO price protection restriction would not apply to certain existing order types (IOC, NOW and PNP orders) and proposed new order types (Passive Discretionary, Discretion Limit, IOC Cross and PNP Cross) [16] in Nasdaq securities. The definition for IOC, NOW, PNP, Passive Discretionary and Discretion Limit order types [17] includes a provision clarifying that the NBBO price protection requirement set forth in rule 7.37 will not apply to these order types in Nasdaq securities. Unlike the market for listed securities, there is no linkage between participants in the Nasdaq UTP Plan and, therefore, no rules that prohibit a participant from trading through another participant's quote.[18] Consequently, the Exchange believes that it would not be praticable to attempt to provide such orders with intermarket price protection. The

[12] The Display Order Process is the second step in the ArcaEx execution algorithm. In this process, the ArcaEx system matches an incoming marketable order against orders in the Display Order Process at the display price of the resident order for the total size available at the that price or for the size of the incoming order. *See* PCXE rule 7.37(b) (description of ''Display Order Process'').

[13] *See* proposed PCXE rule 7.31(cc) (definition of ''Pegged Order'').

[14] *See* Securities Exchange Act Release No. 46428 (August 28, 2002), 67 FR 56607 (September 4, 2002) (Order Pursuant to Section 11A of the Act and Rule 11Aa3–2(f) thereunder Granting a De Minimus Exemption for Transactions in Certain ETFs from the ITS Trade-Through Provisions. *See also* Securities Exchange Act Release No. 46684 (October 17, 2002), 67 FR 65618 (October 25, 2002) (SR-PCX–2002–69).

[15] The Exchange notes that it has filed a separate proposed rule change relating to IOC Cross and PNP Cross Orders. *See* Securities Exchange Act Release No. 47010 (December 16, 2002), 67 FR 78554 (December 24, 2002) (SR–PCX–2002–74).

[16] *Id.*

[17] *See generally* PCXE rule 7.31.

[18] *See* note 1, *supra.*

Exchange also believes that these proposed orders are sophisticated types of orders, and persons using these orders will understand the benefits and limitations of their use. Moreover, such orders are still subject to a broker's duty of best execution for its customer.

3. *Working Order Process*

The Exchange proposes the following conforming changes to certain provisions of the Working Order Process set forth in PCXE rule 7.37(b)(2):

a. *Current PCXE Rule 7.37(b)(2)(C)*—This section has been modified to clarify the conditions in which a Passive Discretionary Order and Discretion Limit Order would be routed to an away market participant's quote. Passive Discretionary Orders would be routed away only if the displayed price is marketable against an away market participant. Discretion Limit Orders would be routed away only if the displayed share size of such order is equal to or less than the displayed share size of the away market participant.

b. *Proposed PCXE Rule 7.37(b)(2)(A)(iv)*—Several pricing scenarios have been added to the Working Order Process regarding incoming marketable orders that could be matched against a Passive Discretionary Order. First, for Nasdaq securities, if the BBO is outside the NBBO and a Passive Discretionary Order(s) within the Working Order Process has a discretionary price worse than the NBBO, then the incoming order would execute against such Passive Discretionary Order(s) at the price of the incoming order or the displayed price of the Discretionary Order(s), whichever is better. Second, for Nasdaq securities, if the BBO is outside the NBBO and a Passive Discretionary Order(s) within the Working Order Process has a discretionary price equal to or better than the NBBO, then the incoming order would execute against such Passive Discretionary Order(s) pursuant to current rule 7.37(b)(2)(A)(ii). Finally, for ITS Trade-Through Exempt Securities (as defined in rule 7.37), if the BBO is outside the NBBO and a Passive Discretionary Order(s) within the Working Order Process has a discretionary price worse than the NBBO by three cents ($0.03) or less, the incoming order would execute against such Passive Discretionary Order(s) at the price of the incoming order or the displayed price of the Discretionary Orders(s), whichever is better.

4. *Technical Changes*

Minor technical changes have been made throughout PCXE rules 1.1 and 7.18 to conform to the Nasdaq UTP Plan, which extends UTP to Nasdaq SmallCap securities. Accordingly, the Exchange is proposing to delete references to the term ''Nasdaq/NM Security'' and replacing it with ''Nasdaq Security.'' In addition, several definitions contained in rule 1.1 are being amended to reflect the change in name of the Nasdaq UTP Plan. Finally, current PCXE rule 1.1(jj), which defines the term ''OTC/UTP Primary Market,'' is being amended to reflect that the Listing Market, rather than the Primary Market, would have the authority to call a Regulatory Halt pursuant to PCXE rule 7.18(c). A definition of ''OTC/UTP Listing Market'' is being adopted from the Nasdaq UTP Plan.[19]

The Exchange believes that the implementation of the aforementioned order types will facilitate enhanced order interaction and foster price competition. The proposal also promotes a more efficient and effective market operation, and provides market participants with greater flexibility in determining how their orders would be executed.

Statutory Basis

The Exchange believes that the proposed rule change is consistent with section 6(b) of the Act, [20] in general, and further the objectives of section 6(b)(5),[21] in particular, because 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. In addition, the Exchange believes that the proposed rule change is consistent with provisions of section 11A(a)(1)(B) of the Act,[22] which states that new data processing and communications techniques create the opportunity for more efficient and effective market operations.

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 PCX consents, the Commission will:

(A) By order approve such proposed rule change; or

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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 filings will also be available for inspection and copying at the principal office of the PCX. All submissions should refer to File No. SR–PCX–2002–75 and should be submitted by February 19, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[23]

Margaret H. McFarland,

Deputy Secretary.

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[19] *Id.*

[20] 15 U.S.C. 78f(b).

[21] 15 U.S.C. 78f(b)(5).

[22] 15 U.S.C. 78k–1(a)(1)(B).

[23] 17 CFR 200.30–3(a)(12).