

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44983; File No. SR-PCX-00-25]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Pacific Exchange, Inc., as Amended, and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 4 and 5 Concerning the Establishment of the Archipelago Exchange as the Equities Trading Facility of PCX Equities, Inc.

October 25, 2001.

#### I. Introduction

On July 31, 2000, pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> the Pacific Exchange, Inc. (“PCX”) filed with the Securities and Exchange Commission (“Commission” or “SEC”) a proposed rule change to create a new electronic trading facility called the Archipelago Exchange (“ArcaEx”). The PCX filed Amendment No. 1 to the proposal on November 9, 2000. The proposed rule change, as amended by Amendment No. 1, was published for comment and appeared in the **Federal Register** on December 15, 2000.<sup>3</sup> The Commission received 10 comment letters.<sup>4</sup> The PCX filed Amendment No. 2 to the proposal on February 27, 2001. On April 20, 2001, the PCX filed Amendment No. 3 to the proposal, which replaced Amendment

No. 2 in its entirety. Notice of the proposed rule change, as amended by Amendment No. 3, was published in the **Federal Register** on May 8, 2001.<sup>5</sup> The Commission received two comment letters on Amendment No. 3.<sup>6</sup> On July 19, 2001, the PCX filed Amendment No. 4 to the proposed rule change.<sup>7</sup> On October 9, 2001, the PCX filed Amendment No. 5 to the proposed rule change. This order approves the PCX’s proposed rule change, as amended, publishes notice of Amendment Nos. 4 and 5 to the proposed rule change, and grants accelerated approval of Amendment Nos. 4 and 5.

#### II. Description of the Proposal

##### A. Introduction

The PCX proposes to establish ArcaEx as the new electronic communications and trading facility<sup>8</sup> of its subsidiary, PCX Equities, Inc. (“PCXE”). Operating in place of PCXE’s traditional trading floor, the ArcaEx facility would automatically execute orders in equity securities listed or traded on the PCXE.<sup>9</sup> As described further below, ArcaEx market makers would replace the PCX’s traditional floor specialists.<sup>10</sup>

As a facility of the PCX, ArcaEx would be subject to the Commission’s oversight and examination. Consequently, the Commission would have the same authority to oversee the premises, personnel, and records of ArcaEx as it currently has with respect to the PCX. In addition, the PCX would be fully responsible for all activity that takes place through ArcaEx, and persons using ArcaEx would be subject to PCXE rules. For example, under the proposal, the PCX would conduct all necessary surveillance of the operation of ArcaEx

and would maintain an audit trail of trading through ArcaEx. The PCX would rely on its own regulatory staff, and not on the employees of ArcaEx or its parent companies, to perform its regulatory functions concerning ArcaEx.

The Archipelago Exchange LLC, a subsidiary of Archipelago Holdings LLC, would operate the ArcaEx facility, and would be responsible for ArcaEx’s business activities to the extent that those activities are not inconsistent with the regulatory and oversight functions of the PCX and PCXE.<sup>11</sup> This means that Archipelago Exchange LLC will not interfere with the PCX’s self-regulatory responsibilities. The PCX currently has a 10% ownership interest in Archipelago Holdings LLC.<sup>12</sup> Pursuant to contractual agreement, the PCX has the right to appoint a representative to the board of Archipelago Holdings LLC. The current rules of PCXE allow an officer or director of a PCX trading facility to have a single seat on the PCXE’s board.<sup>13</sup> By operation of PCX rules, the books, records, premises, officers, directors, agents, and employees of Archipelago Exchange LLC, which owns and operates the ArcaEx, would be deemed to be those of the PCX and PCXE for purposes of the Act. Moreover, all officers and directors of ArcaEx’s parent company, Archipelago Holdings LLC, would be deemed officers and directors of PCX and PCXE for purposes of the Act.<sup>14</sup>

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

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

<sup>3</sup> Securities Exchange Act Release No. 43608 (November 21, 2000), 65 FR 78822 (December 15, 2000).

<sup>4</sup> Letter from Lanny A. Schwartz, Executive Vice President and General Counsel, Philadelphia Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Dec. 21, 2000 (“Phlx Letter”); letter from John F. Malitzis, Associate General Counsel, Nasdaq Stock Market Inc., to Jonathan G. Katz, Secretary, SEC, dated Dec. 28, 2000 (“Nasdaq Letter 1”); letter from San Francisco Specialists Association to Jonathan G. Katz, Secretary, SEC, dated Jan. 3, 2001 (“SFSA Letter”); letter from Los Angeles Specialists Association, to Jonathan G. Katz, Secretary, SEC, dated Jan. 4, 2001 (“LASA Letter”); letter from David Hultman, D.A. Davidson & Co., to Jonathan G. Katz, Secretary, SEC, dated Jan. 5, 2001 (“D.A. Davidson Letter”); letter from Jeffrey T. Brown, Cincinnati Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Jan. 8, 2001 (“CSE Letter”); letter from Richard G. Ketchum, President, Nasdaq Stock Market Inc., to Jonathan G. Katz, Secretary, SEC, dated Jan. 22, 2001 (“Nasdaq Letter 2”); letter from Robert R. Glauber, Chief Executive Officer and President, NASD Regulation, Inc., to Jonathan G. Katz, Secretary, SEC, dated Jan. 26, 2001 (“NASD Regulation Letter”); letter from Steve Wunsch, President, Arizona Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated Feb. 1, 2001 (“AZX Letter”); and 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 1”).

<sup>5</sup> Securities Exchange Act Release No. 44233 (April 30, 2001), 66 FR 23291 (May 8, 2001).

<sup>6</sup> See letter from Michael T. Dorsey, Senior Vice President, General Counsel and Secretary, Knight Trading Group, Inc., to Jonathan G. Katz, Secretary, SEC, dated June 22, 2001 (“Knight Letter 2”) and letter from Richard G. Ketchum, President, Nasdaq Stock Market Inc., to Jonathan G. Katz, Secretary, SEC, dated June 4, 2001 (“Nasdaq Letter 3”).

<sup>7</sup> In Amendment No. 4 to the proposed rule change, the PCX added new subsection (d) to proposed PCXE Rule 14.3, which would require that Archipelago Exchange LLC and Archipelago Holdings LLC maintain all books and records related to the ArcaEx within the United States. In addition, the PCX made technical changes to various proposed rules. By letter dated October 24, 2001, Archipelago Holdings LLC withdrew its Form 1 application to register as an exchange.

<sup>8</sup> See 15 U.S.C. 78c(a)(2) (definition of “facility”).

<sup>9</sup> The PCX has delegated its self-regulatory authority to the PCXE. See Securities Exchange Act Release No. 42759 (May 5, 2000), 65 FR 30654 (May 12, 2000).

<sup>10</sup> The proposal does not require that a market maker be assigned to every PCXE security. See proposed PCXE Rule 1.1(u) (definition of “market maker”).

<sup>11</sup> See proposed PCXE Rule 14.3. See also Amendment No. 3 to the proposed rule change, Securities Exchange Act Release No. 44233 (April 30, 2001), 66 FR 23291 (May 8, 2001).

<sup>12</sup> See PCX Annual Report at <http://www.pacificex.com/about/2001AnnualReport/EQUITIES/equities.html>, visited on August 21, 2001.

<sup>13</sup> See Securities Exchange Act Release No. 44442 (June 18, 2001), 66 FR 33733 (June 25, 2001).

<sup>14</sup> The relationship between the PCX, PCXE, and the Archipelago entities is explained in proposed PCXE Rule 14.3. Under proposed PCXE Rule 14.3(a), the books, records, premises, officers, directors, agents, and employees of Archipelago Exchange LLC would be deemed to be the books, records, premises, officers, directors, agents, and employees of the PCX and PCXE for purposes of and subject to oversight under the Act. The books and records of Archipelago Exchange LLC would be subject at all times to inspection and copying by the PCX, PCXE, and the Commission. Under proposed PCXE Rule 14.3(b), all officers and directors of Archipelago Holdings LLC would be deemed to be officers and directors of the PCX and PCXE for purposes of and subject to oversight under the Act. Under proposed PCXE Rule 14.3(d), Archipelago Exchange LLC and Archipelago Holdings LLC would be required to maintain all books and records related to the Archipelago Exchange within the United States. See Amendment No. 4 to the proposed rule change.

### B. Trading on ArcaEx

Equity Trading Permit (“ETP”) Holders<sup>15</sup> and other users<sup>16</sup> of ArcaEx would be able to submit orders to an electronic file of orders, called the “Arca Book,”<sup>17</sup> where trades would be executed at prices equal to or better than the national best bid or offer (“NBBO”). ArcaEx users could choose to have their unexecuted orders left on the Arca Book, returned to them, or routed to other markets.<sup>18</sup> A broker-dealer subsidiary of Archipelago Holdings LLC, Wave Securities LLC (“Wave”), would serve as an optional mechanism for routing the orders of ArcaEx users to other market centers.<sup>19</sup> ArcaEx users who do not choose to use Wave could establish routing arrangements with other providers of order-routing services or use their own proprietary routing mechanisms.

The Arca Book would feature four trading processes dealing with directed orders,<sup>20</sup> display orders,<sup>21</sup> working orders,<sup>22</sup> and tracking orders,<sup>23</sup> respectively. In the directed order process, a user could direct an order to a particular market maker, including itself.<sup>24</sup> In the display order and working order processes, orders would be ranked and maintained in the Arca Book according to price-time priority with displayed orders and prices having priority over undisplayed orders, sizes, and prices. In the tracking order process, orders that were not filled through the first three processes could be matched with tracking orders in accordance with the users’ stated instructions. Finally, at the customer’s option, orders not matched on the Arca

<sup>15</sup> See proposed PCXE Rule 1.1(n) (definition of “ETP Holder”).

<sup>16</sup> A user is any ETP Holder or sponsored participant who is authorized to obtain access to ArcaEx. See proposed PCXE Rule 1.1(o).

<sup>17</sup> See proposed PCXE Rule 1.1(a) (the Arca Book contains all the user’s orders in each of the directed order, display order, working order and tracking order processes).

<sup>18</sup> See proposed PCXE Rule 7.37 (describing ArcaEx’s order execution processes).

<sup>19</sup> As discussed more fully in part IV, *infra*, Wave would also act as an introducing broker and would function as an electronic communications network for the limited number of securities that would not be eligible to trade on ArcaEx.

<sup>20</sup> See proposed PCXE Rule 7.37(a) (description of “directed order process”).

<sup>21</sup> See proposed PCXE Rule 7.37(b)(1) (description of “display order process”).

<sup>22</sup> See proposed PCXE Rule 7.37(b)(2) (description of “working order process”).

<sup>23</sup> See proposed PCXE Rule 7.37(c) (description of “tracking order process”).

<sup>24</sup> But see PCXE Rule 7.43, submitted in Amendment No. 3 to the proposed rule change. (A market maker’s ability to direct proprietary orders to itself would be limited because the practice could violate just and equitable principles of trade.)

Book may be routed to a different market center for execution.

#### 1. The Directed Order Process

Any market or limit order to buy or sell that has been directed to a particular market maker is referred to as a “directed order.”<sup>25</sup> A market maker would be allowed to submit standing “directed fill” instructions, including such parameters as the size of the order, the price improvement algorithm, the period of time that the instruction is effective, and the identity of the users that may send the market maker a directed order.<sup>26</sup> A directed order transaction would not take place unless a corresponding directed fill would execute the trade at a better price than any displayed order held in the Arca Book and in any case at the NBBO or better. Directed orders and directed fills are not displayed. Any directed order that is unexecuted or partially executed against a directed fill would enter the display order process.

#### 2. The Display and Working Order Processes

All limited price orders<sup>27</sup> submitted to ArcaEx would be ranked and maintained in the display order process or the working order process of the Arca Book. Orders in those processes would be ranked according to price-time priority such that within each price level all orders would be assigned priority according to the time of entry.

Users of ArcaEx would be able to submit discretionary orders, reserve orders, and all-or-none orders—collectively referred to as “working orders”—that have conditional or undisplayed prices and/or sizes.<sup>28</sup> A discretionary order is 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. For

<sup>25</sup> See proposed PCXE Rule 7.31(i). A directed order is defined as “any market or limit order to buy or sell which has been directed to a particular market maker by the user.”

<sup>26</sup> See proposed PCXE Rule 7.31(j). A directed fill is a limit order with (1) a size that is equal to or less than the size of the directed order and (2) a price that improves the best bid or offer by an automatically preset amount, which must be equal to or greater than the minimum price improvement interval, pursuant to a price improvement algorithm; provided, however, that the directed fill will not be generated if the price is not equal to or better than the national best bid or offer.

<sup>27</sup> A “limited price order” is any order with a specified price or prices (e.g., limit orders and working orders) other than stop orders. See proposed PCXE Rule 1.1(s). Directed orders and tracking orders are limited price orders that are not displayed and are not handled within the display order process. See proposed PCXE Rule 7.31.

<sup>28</sup> See proposed PCXE Rule 7.31(h) (definition of “working order”).

example, a user could submit an order to buy 5000 shares of XYZ at 20, with discretion to buy at a price up to 20.25. In that case, the order is represented at a displayed price of 20, but under prescribed conditions the order may be filled partially or completely, at any allowable price up to the maximum discretionary price of 20.25.

A reserve order is a limit order with a portion of the size displayed and with a reserve portion of the size (the “reserve size”) not displayed on the Arca Book. For example, a user could submit an order to buy 5000 shares of XYZ at 20 with a request that 1000 shares be displayed. Therefore, the 1000 shares would be displayed and the 4000 share reserve size would not be displayed until the displayed size is exhausted. An all-or-none order is a limit order that is to be executed in its entirety or not at all. All-or-none orders would not be displayed.

The display order process would include market orders, limit orders, and limit orders entered by market makers, known as “Q orders.”<sup>29</sup> In addition, the display order process includes the displayed portions of discretionary orders and reserve orders. Discretionary orders would be ranked in the display order process based on the displayed price and the time of order entry. If a discretionary order were decremented, it would remain ranked based on the displayed price and the time of original order entry. The displayed portion of reserve orders would be ranked in the display order process at the specified limit price and the time of order entry.

All-or-none orders and the undisplayed portion of discretionary orders and reserve orders would be ranked in the working order process. Discretionary orders would be ranked in the working order process based on the displayed price and the time of original order entry. If a discretionary order were decremented, it would retain its standing in order priority. The reserve portion of reserve orders would be ranked in the working order process based on the specified limit price and the time of original order entry. If the displayed portion of the reserve order were exhausted, the displayed portion of the reserve order would be refreshed from the reserve portion at the original displayed amount, and would be submitted and ranked at the specified limit price and at the new time that the displayed portion of the order was refreshed. After the displayed portion of a reserve order is refreshed from the reserve portion, the reserve portion

<sup>29</sup> See proposed PCXE Rule 7.31(k) (definition of “Q order”). A Q order may not be a working order.

would remain ranked based on the original time of order entry, while the displayed portion would be sent to the display order process with a new time stamp. All-or-none orders would be ranked in the working order process based on the specified limit price and the time of order entry.

### 3. Examples

The PCX offers the following example to clarify how orders would be ranked in the display and working order processes. Suppose that users submit the following orders to ArcaEx:

10:00 a.m.—Order A—Limit order to buy 1000 XYZ at 20  
 10:01 a.m.—Order B—Reserve order to buy 5000 XYZ at 20 (show 1000)  
 10:02 a.m.—Order C—Limit order to buy 500 XYZ at 20  
 10:03 a.m.—Order D—Discretionary order to buy 5000 XYZ at 20 (discretion to 20.25)  
 10:04 a.m.—Order E—All-or-none to buy 1500 XYZ at 20  
 10:05 a.m.—Order F—Q order to buy 1000 XYZ at 20  
 10:06 a.m.—Order G—Limit order to buy 700 XYZ at 20  
 10:07 a.m.—Order H—Q order to buy 500 XYZ at 20  
 10:08 a.m.—Order I—Discretionary order to buy 10,000 XYZ at 20 (discretion to 20.25)

In the display order process, Orders A–H would be ranked in the Arca Book in the following order:

- (1) Order A;
- (2) Order B1 (the displayed 1000 shares of Order B);
- (3) Order C;
- (4) Order D1 (the displayed price of 20 for Order D);
- (5) Order F;
- (6) Order G;
- (7) Order H; and
- (8) Order I1 (the displayed price of 20 for Order I).

In the working order process, the orders would be ranked in the Arca book in the following order:

- (1) Order B2 (4000 shares of the reserve portion of Order B);
- (2) Order D2 (the discretionary price up to 20.25 for Order D);
- (3) Order E; and
- (4) Order I2 (the discretionary price up to 20.25 for Order I).

### 4. The Tracking Order Process

If an order has not been executed in its entirety after progressing through the directed order, display order, and working order processes, the order (or the remaining portion of the order) would enter the tracking order process. An incoming order may be matched to

tracking orders held in the tracking order process in accordance with a user's set parameters, such as maximum aggregate size, maximum tradeable size, and the price in relation to the NBBO. Once a user has entered the parameters of a tracking order, the parameters may not be changed.<sup>30</sup> Like a directed fill, a tracking order would be executed only at the NBBO or better. Tracking orders are not displayed.

#### C. Early, Core, and Late Trading Sessions

ArcaEx would maintain three sessions each trading day: the opening session, the core trading session, and the late trading session.<sup>31</sup> The opening session would begin at 5:00 a.m. (Pacific Time) with an opening auction in which only limited price orders would be eligible. The opening session would conclude with a market order auction in which both market and limited price orders would be eligible. The market order auction would begin at 6:30 a.m. (Pacific Time). The core trading session would begin for each security at 6:30 a.m. (Pacific Time) or at the conclusion of the market order auction for such security, whichever comes later, and conclude at 1:00 p.m. (Pacific Time). The late trading session would begin after the conclusion of the core trading session and conclude at 5:00 p.m. (Pacific Time).

Market makers have certain obligations in the market order auction and core trading session. A market maker would be required to enter at least one "cleanup order" for each security in which it is registered for each market order auction.<sup>32</sup> When trading in the core session begins, market makers would be obligated to enter and maintain continuous, two-sided limit orders (*i.e.*, Q orders) in the securities in which they are registered. The directed order process and the tracking order process would not be available during the opening and late sessions. Market orders would be available during the core trading session, would not be available during the late trading session, and would be available only for the market order auction during the opening trading session.

For each day order entered into ArcaEx, the entering user would have to designate the trading sessions for which

<sup>30</sup> The instructions would remain in effect until the user's aggregate size limit were achieved or the day's trading session ended. *See* proposed PCXE Rule 7.31(f) (description of tracking orders).

<sup>31</sup> *See* proposed PCXE Rule 7.34 (description of "trading sessions").

<sup>32</sup> *See* proposed PCXE Rule 7.31(u) (description of "cleanup orders").

the order would be in effect. Any good-till-cancelled order entered into ArcaEx would be in effect only during core trading sessions unless the entering user specifically instructs otherwise.

### III. Comments Received

The Commission received twelve comment letters from nine commenters.<sup>33</sup> A majority of the commenters supported the proposal.<sup>34</sup> Two commenters that operate electronic markets, the Arizona Stock Exchange ("AZX") and the Cincinnati Stock Exchange, stated that the proposal would benefit market participants, including retail investors, by bringing innovation and increased competition to the securities markets.<sup>35</sup> In particular, the AZX stated its support for the proposed auction method and sophisticated electronic surveillance capabilities.

Several PCXE members expressed strong support for the proposal and encouraged the Commission to expedite the approval process. D.A. Davidson & Co. stated its intention to participate on ArcaEx as both a market maker and a retail order flow provider, and noted that the proposal will "create a new national marketplace which will level the playing field for all participants."<sup>36</sup> Two commenters, the Los Angeles Specialists Association ("LASA") and the San Francisco Specialists Association ("SFSA"), strongly supported replacing the PCX's physical trading floor with the fully electronic order execution facility. LASA and SFSA believe that all investors would have equal access to information and would benefit from immediate electronic executions, possible price improvement, and anonymity on ArcaEx.<sup>37</sup> Further, in offering their strong support for the proposal, LASA and SFSA cited the proposed regulatory structure and ArcaEx's unique order execution algorithm, sophisticated order routing mechanism, and ability to attract corporate issuers.

In contrast, three commenters submitted a total of five letters opposing the proposal.<sup>38</sup> The Philadelphia Stock Exchange, Inc. ("Phlx") stated that the

<sup>33</sup> *See* note 4, *supra*.

<sup>34</sup> NASD Regulation Inc. submitted a letter that neither supported nor opposed the proposal but urged the Commission to consider the regulatory relationship between any new exchange and existing self-regulatory organizations. *See* NASD Regulation Letter, *supra* note 4.

<sup>35</sup> *See* AZX Letter and CSE Letter, *supra* note 4.

<sup>36</sup> *See* D.A. Davison Letter, *supra* note 4.

<sup>37</sup> *See* LASA Letter and SFSA Letter, *supra* note 4.

<sup>38</sup> *See* Phlx Letter, Knight Letter 1, and Nasdaq Letter 2, *supra* note 4; Knight Letter 2, and Nasdaq Letter 3, *supra* note 6.

proposal was inconsistent with section 11(a) of the Act because public customer agency orders would not have priority over broker-dealer proprietary orders.<sup>39</sup> In support of this position, the Phlx argued that broker-dealers would have an informational advantage over public customers even though transactions would take place on a fully electronic system as opposed to a physical trading floor. The Phlx argued that the Commission should condition approval of the proposal on the requirement that customer orders be given priority.

The Nasdaq Stock Market, Inc. ("Nasdaq") submitted two letters opposing the proposal.<sup>40</sup> Nasdaq argued that, by seeking approval for ArcaEx as a facility of PCXE through the rule filing process under section 19 of the Act, the PCX and ArcaEx have improperly circumvented the exchange registration process. In Nasdaq's view, the PCX should obtain a controlling ownership interest in Archipelago Holdings LLC or ArcaEx should seek registration as a national securities exchange under section 6 of the Act. Taking note that the PCX previously regulated a competing specialist system, Nasdaq asserted that the PCX's regulatory structure was insufficient for regulating a competing dealer market. Nasdaq also questioned whether the proposal would ensure an adequate audit trail with respect to trading in Nasdaq securities.

Nasdaq also believes that an exchange is statutorily obligated to guarantee liquidity in its marketplace. Noting that there is no requirement under the proposal that a market maker be assigned to every ArcaEx security, Nasdaq asserted that the PCX would be unable to guarantee liquidity in its marketplace. Nasdaq also raised concerns with respect to ArcaEx's integration into the national market system, and contended that the requirement that users enter into a routing agreement raised best execution issues and could amount to a denial of access.

Knight Trading Group, Inc. ("Knight") questioned whether the PCX plans to impose fees on market participants that trade Nasdaq/NM securities admitted to unlisted trading privileges on ArcaEx, and asserted that expanding trading in the over-the-counter market potentially

<sup>39</sup> See Phlx Letter, *supra* note 4; *see also* discussion in Part IV.D., *infra*. The Commission notes that proposed PCXE Rule 6.16(a) would prohibit ETP Holders from trading ahead of their customer limit orders.

<sup>40</sup> See Nasdaq Letter 2, *supra* note 4; Nasdaq Letter 3, *supra* note 6. In Nasdaq Letter 1, Nasdaq requested that the Commission extend the period for comment on the proposal as amended by Amendment No. 1. See Nasdaq Letter 1, *supra* note 4.

could place Nasdaq market makers that are not ETP Holders at a competitive disadvantage and disrupt the Nasdaq market.<sup>41</sup> In Knight's view, the proposal would provide an opportunity for Nasdaq securities to trade on ArcaEx through the OTC-UTP Plan<sup>42</sup> to the detriment of Nasdaq market makers.<sup>43</sup>

The PCX submitted three letters in response to the comments.<sup>44</sup> The PCX reiterated its belief that ArcaEx should properly be regulated as a facility of an exchange, and asserted that regulating ArcaEx as a facility is consistent with the Commission's regulation of facilities operated by other exchanges. Furthermore, the PCX stated that the relationship between the PCX and ArcaEx satisfies the regulatory requirements of the Act.

In response to Nasdaq concerns about ArcaEx's integration into the national market system, particularly the Intermarket Trading System ("ITS"), the PCX stated that it intends to comply with the national market system plans in connection with the operation of ArcaEx. Consistent with the terms of the ITS Plan, the PCX will not charge fees to non-members using ITS to access ArcaEx.<sup>45</sup> With regard to the concerns that commenters raised about the PCX's ability to conduct adequate surveillance of ArcaEx, the PCX argued 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

<sup>41</sup> See Knight Letter 1, *supra* note 4; Knight Letter 2, *supra* note 6. The Commission notes that the PCX intends to submit a separate filing pursuant to Section 19(b) of the Act to establish its fees.

<sup>42</sup> See Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Exchange-listed Nasdaq/National Market System Securities and for Nasdaq/National Market System Securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("OTC-UTP Plan"). Securities Exchange Act Release No. 24407 (April 29, 1987), 52 FR 17349 (May 7, 1987). *See also* Securities Exchange Act Release No. 36985 (March 18, 1996), 61 FR 12122 (March 25, 1996).

<sup>43</sup> To the extent that Knight's concerns relate to the potential expansion of the OTC-UTP Plan, those issues are more appropriately addressed in the context of the pending proposal to expand the OTC/UTP Plan, which has been noticed for public comment. *See* Securities Exchange Act Release No. 44822 (September 20, 2001), 66 FR 50226 (October 2, 2001).

<sup>44</sup> See letters from Cherie L. Macauley, Wilmer, Cutler & Pickering, to John Polise, Senior Special Counsel, Division, Commission dated February 26, 2001 ("PCX Response 1"), April 19, 2001 ("PCX Response 2"), and August 3, 2001 ("PCX Response 3").

<sup>45</sup> The ITS Plan was designed to facilitate intermarket trading in exchange-listed equity securities based on current quotation information emanating from the linked markets. *See* Securities Exchange Act Release No. 19456 (January 27, 1983), 48 FR 4938 (February 3, 1983).

number of securities."<sup>46</sup> The PCX represents that it will implement a state-of-the-art electronic audit trail system.<sup>47</sup>

In response to Nasdaq's concerns with respect to liquidity, the PCX stated that the Act does not specifically require that a market maker be assigned to each security traded on an exchange. Moreover, the PCX asserted that under the Commission's new regulatory framework for exchanges, liquidity provided by a market maker is not an essential element of an exchange.

Comments also questioned the proposed use of discretionary orders and the role of Wave on the ArcaEx. In particular, Nasdaq expressed the view that the use of discretionary orders would violate Rule 11Ac1-1<sup>48</sup> and that Wave, the broker-dealer subsidiary of Archipelago Holdings LLC, should be regulated as a facility of the PCX. More detailed summaries of those comments and the PCX's responses to them are included in part IV, *infra*.

#### IV. Discussion

After careful review and consideration of the comments, the Commission finds, for the reasons discussed below, that the ArcaEx proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the PCX.

The Commission historically has encouraged exchanges to integrate new data communications and trade execution mechanisms into their marketplaces in order to further these goals of the national market system. In recent years, for example, the Commission's Order Handling Rules<sup>49</sup> and Regulation ATS<sup>50</sup> sought to bring alternative trading systems ("ATSSs"), including electronic communications networks ("ECNs"), into the framework of the national market system. In addition, the Commission approved the Nasdaq SuperMontage,<sup>51</sup> NYSE Direct+,<sup>52</sup> the application of the

<sup>46</sup> See PCX Response 1 and PCX Response 2.

<sup>47</sup> See PCX Response 2.

<sup>48</sup> 17 CFR 240.11Ac1-1.

<sup>49</sup> See Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) ("Order Handling Rules").

<sup>50</sup> See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998) ("ATS Release"). Generally, the ATS Release established a new regulatory framework that gives securities markets the choice to register as exchanges or as broker dealers, and also provided guidance to those markets that wished to register as national securities exchanges.

<sup>51</sup> See Securities Exchange Act Release No. 43863, (January 19, 2001), 66 FR 8020 (January 26, 2001) (Order approving the Nasdaq SuperMontage).

<sup>52</sup> Securities Exchange Act Release No. 43767 (December 22, 2000), 66 FR 834 (January 4, 2001) (Order approving NYSE Direct+).

International Securities Exchange to become an all-electronic national securities exchange,<sup>53</sup> and the proposals of the PCX and the NASD to implement trading facilities using applications of the OptiMark System.<sup>54</sup>

In proposing to establish ArcaEx as the equities trading facility of the PCXE, the PCX has sought to replace its floor trading model with a sophisticated electronic trading system. In the Commission's view, the proposed ArcaEx facility would provide a new and technologically advanced way for trading interest to be matched and orders to be executed on the PCX. The Commission believes that, if the ArcaEx facility is able to attract new market participants and to increase order flow to the PCX, the facility could promote greater competition among market centers. In particular, the novel features of the ArcaEx facility may enable retail customers and institutional investors to come together in a new marketplace. For example, institutional investors may be able to use working orders in the ArcaEx facility to represent their trading interest more completely than is currently feasible in other electronic auction facilities.<sup>55</sup> If the ArcaEx facility succeeds in attracting more order flow to the PCX, the PCX may begin to serve as a greater source of liquidity for investors.

In publishing notice of the PCX's proposal, the Commission invited public comment on several important issues and received a number of well-reasoned comment letters that broadly criticized both the form and the function of the proposed ArcaEx facility. The major comments are discussed below.

#### *A. ArcaEx Is an Equities Trading Facility of the PCX*

The Commission believes that the PCX's proposal for ArcaEx to become its facility is properly filed under section 19(b)(1) of the Act,<sup>56</sup> and that it is not necessary for ArcaEx to register as a national securities exchange independent of the PCX under section 6(a) of the Act.<sup>57</sup> Section 19(b)(1) of the

Act<sup>58</sup> requires that every self-regulatory organization ("SRO") file with the Commission copies of any proposed rule or any proposed change to its rules, accompanied by a concise general statement of the basis and purpose of the proposed rule change. The Commission is required to publish notice of the filing of a proposed rule change and to give interested persons an opportunity to submit written data, views, and arguments. Section 19(b)(2) of the Act<sup>59</sup> provides that the Commission shall approve an SRO's proposed rule change if it is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the SRO, or disapprove the proposed rule change if the Commission does not make such a finding. In the Commission's view, the PCX's proposal to establish ArcaEx as an exchange facility is consistent with the Act, as well as with previous proposals of national securities exchanges filed under section 19(b) of the Act<sup>60</sup> to use the personnel and equipment of third parties to operate trading platforms.<sup>61</sup>

The Commission notes that PCXE rules will govern the operation of the ArcaEx facility. PCXE is a wholly-owned subsidiary of the PCX, which is a national securities exchange registered under section 6 of the Act.<sup>62</sup> The PCX, as the SRO, retains ultimate responsibility for its members' compliance with the provisions of the Act and the rules and regulations thereunder. In particular, the PCX must approve any changes to the rules and governing documents of PCXE. Moreover, the PCX must file changes to PCXE's bylaws and rules with the Commission pursuant to section 19(b) of the Act<sup>63</sup> and Rule 19b-4,<sup>64</sup> including any rules relating to its facilities.

In short, as a facility of the PCX, ArcaEx falls under the PCX's self-regulatory authority. In this regard, "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."<sup>65</sup> Although the PCX has delegated to PCXE the authority to administer and manage the PCX's equities trading function, the PCX retains the ultimate responsibility for the operation, administration, rules, and regulation of PCXE.<sup>66</sup> The PCX must review rulemaking and disciplinary decisions of PCXE and direct PCXE to take action that may be necessary to effectuate the purposes and functions of the Act.

ArcaEx would also be subject to Commission oversight and examination as a facility of the PCX. The Commission would oversee the premises, personnel, and records of ArcaEx to the same extent that it currently oversees the premises, personnel, and records of the PCX. Proposed PCXE Rule 14.3(a) states:

The books, records, premises, officers, directors, agents, and employees of Archipelago Exchange LLC 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 LLC shall be subject at all times to inspection and copying by the PCX, PCX Equities and the SEC.

Similarly, proposed PCXE Rule 14.3(b) states that "[a]ll officers and directors of Archipelago Holdings LLC 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."<sup>67</sup> Under proposed PCXE Rule 14.3(d), Archipelago Exchange LLC and Archipelago Holdings LLC must maintain all books and records related to ArcaEx within the United States.<sup>68</sup> The Commission believes that these provisions would adequately enable its oversight of the ArcaEx facility.

The Commission also believes that the PCX's proposal is designed to provide for the rigorous regulatory oversight that the Act requires. Under the proposal, the PCX would use its own regulatory staff, and not the employees of Archipelago Holdings LLC or Archipelago Exchange LLC, to perform its regulatory oversight duties. In addition, the PCX would maintain a full audit trail and would conduct all necessary surveillance of the trading

<sup>53</sup> See Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11388 (March 2, 2000) (File No. 10-127).

<sup>54</sup> See Securities Exchange Act Release No. 39086 (September 17, 1997), 62 FR 50036 (September 24, 1997) (SR-PCX-97-18); Securities Exchange Act Release No. 41967 (September 30, 1999), 64 FR 54704 (October 7, 1999) (SR-NASD-98-85).

<sup>55</sup> The PCX has represented that the ArcaEx displayed portion of the Arca Book will be available to the public in real time via the Archipelago internet web site.

<sup>56</sup> 15 U.S.C. 78s(b)(1).

<sup>57</sup> 15 U.S.C. 78ff(a).

<sup>58</sup> 15 U.S.C. 78s(b)(1).

<sup>59</sup> 15 U.S.C. 78s(b)(2).

<sup>60</sup> 15 U.S.C. 78s(b).

<sup>61</sup> See, e.g., Securities Exchange Act Release No. 41210 (March 24, 1999), 64 FR 15857 (April 1, 1999) (approval of Phlx's VWAP Trading System); Securities Exchange Act Release No. 39086 (September 17, 1997), 62 FR 50036 (September 24, 1997) (approval of PCX's Application of the OptiMark System). See also Securities Exchange Act Release No. 41967 (September 30, 1999), 64 FR 54704 (October 7, 1999) (approval of Nasdaq Application of OptiMark System); Securities Exchange Act Release No. 35030 (November 30, 1994), 59 FR 63141 (December 7, 1999) (approval of Chicago Match System).

<sup>62</sup> 15 U.S.C. 78f.

<sup>63</sup> 15 U.S.C. 78s(b).

<sup>64</sup> 17 CFR 240.19b-4.

<sup>65</sup> PCX Response 2 at p. 5.

<sup>66</sup> See PCXE Rule 14.

<sup>67</sup> The PCX has represented, and the staff has confirmed, that the provisions of proposed PCXE Rule 14.3 are included in the contractual agreements between PCX and Archipelago Holdings LLC. See PCX Response 2 at p. 6.

<sup>68</sup> See Amendment No. 4 to the proposed rule change.

effected through the ArcaEx facility. The PCX would also be required to comply with the Commission's Automation Review Policy, which requires, among other things, that the PCX ensure that ArcaEx has "the capacity to accommodate current and reasonably anticipated future trading volume levels adequately and to respond to localized emergency conditions."<sup>69</sup>

The Commission believes that the PCX possesses the technological capability to develop and maintain a proper audit trail with respect to ArcaEx and the staff expertise and capital resources properly to oversee the new ArcaEx electronic marketplace.<sup>70</sup> In addition, the PCX has agreed that:<sup>71</sup>

- The PCX will demonstrate to the satisfaction of the Commission's staff that it has adequate surveillance programs and procedures in place to monitor trading on the ArcaEx facility;<sup>72</sup> and
- Prior to the start of trading on the ArcaEx facility, the PCX will demonstrate that the development and capabilities of its systems satisfy the Commission's Automation Review Policy ("ARP"); *i.e.*, that it has adequate computer system capacity, integrity and security to support its operation. In particular, PCX should continue to provide to Commission staff the results of testing ArcaEx trading system functionality, external market interfaces, and capacity, fail-over testing to the alternate data center, and mock trade testing with member firms.

Based on the foregoing, including the PCX's agreement with respect to surveillance and compliance with ARP, the Commission believes that the relevant regulatory objectives of the Act have been satisfied, and that the PCX's submission of the proposal under section 19(b) of the Act<sup>73</sup> is appropriate.

Nasdaq suggests that, because the PCX has filed a proposed rule change to establish ArcaEx as its facility, the proposal will receive less rigorous scrutiny than if Archipelago Holdings LLC had filed a Form 1<sup>74</sup> to establish ArcaEx as a national securities

<sup>69</sup> See Securities Exchange Act Release No. 27445 (November 16, 1989), 54 FR 48703, 48705–06 (November 24, 1989); *see also* Securities Exchange Act Release No. 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991).

<sup>70</sup> The Commission notes that the PCX has regulated both a traditional trading floor as well as the OptiMark electronic trading facility.

<sup>71</sup> Letter from Katherine Beck, Senior Vice President and Special Counsel, PCX, to Jonathan G. Katz, Secretary, Commission, dated October 24, 2001.

<sup>72</sup> The Commission notes that, as matter of Commission policy, surveillance programs and procedures are generally kept confidential. The Commission believes that disclosure of specific surveillance procedures could provide information that market participants could use to circumvent regulatory oversight.

<sup>73</sup> 15 U.S.C. 78s(b).

<sup>74</sup> See 17 CFR 249.1.

exchange. The Commission notes that its publication of notice and solicitation of comments on the ArcaEx proposal would have been no different in the Form 1 process than it was in the rule filing process. Indeed, recognizing that the ArcaEx proposal is unique, the Commission has given the public ample opportunity to comment on a market structure initiative of this magnitude. The proposal was formally filed on July 31, 2000, and has been amended five times. The proposal has twice been the subject of notices in the **Federal Register**. In the many months that the proposal has been in the public domain, interested persons, including other SROs, broker-dealers, investors, and other market participants, have submitted substantial, meaningful comments on the proposal.<sup>75</sup> The Commission believes that the public has had an adequate opportunity, pursuant to section 19(b) of the Act, to scrutinize the proposal and submit comments.

Finally, the Commission notes that, as a national registered exchange, the PCX is required to file an amendment to its Form 1 to reflect the agreement relating to the operation of ArcaEx, including a description of its affiliations with other parties, information describing the reporting, clearance, or settlement of transactions in connection with the operations of the facility, and a copy of existing by-laws or corresponding rules and instruments.<sup>76</sup>

#### B. A Market Maker Is Not Required for Every Security Traded on ArcaEx

Broker-dealers that register as market makers on ArcaEx would be required to maintain two-sided quotes, and would thereby provide a source of liquidity to the ArcaEx marketplace. Although the PCX believes that broker-dealers will make markets in many securities traded on ArcaEx, the proposed PCXE rules allow securities to be traded on ArcaEx without a registered market maker.

Nasdaq argues that PCX's failure to require a market maker in every security is a "clear statutory deficiency." In Nasdaq's view, the "most fundamental requirement" of an exchange is to provide a "ready source of liquidity," and therefore a market maker or specialist must be assigned to each security listed on an exchange.<sup>77</sup>

<sup>75</sup> A complete description of the rule filing, as well as such documents as the Equity Trading Permit Application, the Wave Routing Agreement, and other contracts for ArcaEx users, have also been available to the public via the internet. *See* <http://www.tradearpa.com/exchange>, visited on August 21, 2001.

<sup>76</sup> See Rule 6a–2, 17 CFR 240.6a–2; *see also* Form 1, 17 CFR 249.1.

<sup>77</sup> Nasdaq Letter 2 at p.10.

In the ATS Release,<sup>78</sup> the Commission specifically addressed the question whether the Act requires an exchange to guarantee liquidity in its marketplace. The Commission stated that, although traditional exchanges provide liquidity through two-sided quotations and therefore raise an expectation of execution at the quoted price, modern technology now enables market participants and investors to tap simultaneous and multiple sources of liquidity from remote locations. Significantly, the Commission rejected the suggestion that a guaranteed source of liquidity was a necessary component of an exchange.<sup>79</sup> The Commission notes that, although market makers could be important sources of liquidity on the ArcaEx, they would not be the sole source. In particular, the Arca Book is specifically designed to match the buying and selling interest of all users of ArcaEx. ArcaEx is not required to ensure that a market maker is registered in every PCXE security in order to be the core exchange facility of PCXE.<sup>80</sup>

#### C. Discretionary Orders Under the Quote Rule

##### 1. The Discretionary Order Type

As discussed in part II, above, a user of ArcaEx would be able to submit a type of order called a discretionary order, which is an order to buy or sell a stated amount of a security at a specified, undisplayed price as well as at a specified, displayed price.<sup>81</sup> A non-marketable discretionary order would be displayed to all users at the displayed price, but the discretionary prices of the order would not be displayed. The undisplayed prices of a discretionary order would be represented in the working order process and could be matched with orders on the other side of the market under prescribed conditions.<sup>82</sup> The PCX believes that, because the discretionary order type

<sup>78</sup> Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998).

<sup>79</sup> ATS Release, 63 FR at 70898; *see also* Section 3(a)(1) of the Act, 15 U.S.C. 78c(a)(1), and Rule 3b–16, 17 CFR 240.3b–16 (definition of "exchange").

<sup>80</sup> The Commission notes that, under the previous PCX equities trading rules, securities that were not traded with sufficient frequency to warrant the attention of a specialist were nonetheless traded on the PCX pursuant to "cabinet trading programs." *See* PCX Rule 7.20. 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. *See also* Section 11A(a)(1)(C) of the Act, 15 U.S.C. 78k–1(a)(1)(C) (opportunity for investors' orders to be executed without the participation of a dealer).

<sup>81</sup> *See* proposed PCXE Rule 7.31(h)(2) (definition of "discretionary order").

<sup>82</sup> *See* proposed PCXE Rule 7.37 (description of ArcaEx order execution process).

allows a user to represent a single order at multiple price points, investors would be able to express their trading interest more accurately than is possible with traditional order types. In this way, according to the PCX, ArcaEx would replicate the dynamics of a floor trading model in an electronic environment.

## 2. The Quote Rule

In its comment letters, Nasdaq questioned whether ArcaEx's discretionary orders comply with the Commission's "Quote Rule," Rule 11Ac1-1 under the Act.<sup>83</sup> The Quote Rule requires exchanges to collect bids, offers, quotation sizes, and aggregate quotation sizes from "responsible brokers or dealers" and to make the best prices and aggregate quotation sizes available to quotation vendors.<sup>84</sup> In addition, responsible brokers and dealers must promptly communicate their best bids, offers, and quotation sizes to their exchange and be firm for their published bids and offers in any amount up to their published quotation sizes.<sup>85</sup>

The Quote Rule applies only to trading interest among brokers and dealers that falls within the definition of a bid or an offer. Specifically, the Quote Rule defines "bid" and "offer" as 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, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, but shall not include indications of interest."<sup>86</sup> Therefore, a responsible broker or dealer must do more than simply indicate its interest in trading; it must affirmatively communicate its intentions to at least one other potential counter-party in the form of a cognizable bid or an offer in order to come under the Quote Rule.

In response to these concerns, the PCX argues that discretionary orders comply with both the letter and the spirit of the Quote Rule. First, the PCX argues that discretionary orders are consistent with the Quote Rule because the discretionary prices are communicated only to the exchange and

not to another counter-party.<sup>87</sup> The essence of this argument is that the discretionary price of the discretionary order is not *displayed*, it is not *communicated* to another member or customer, and therefore that price does not qualify as a "bid" or an "offer." Second, the PCX argues that undisplayed, discretionary prices represent "inchoate trading interest," and are therefore excluded from the Quote Rule's definition of bid and offer as "indications of interest." In this regard, the PCX contends that discretionary orders are analogous to OptiMark Profiles, a feature of the PCX's former OptiMark equities trading facility.<sup>88</sup>

## 3. Analysis of Discretionary Orders

The Commission is not persuaded by Nasdaq's assertion that discretionary orders would violate the Quote Rule. Although the Commission recognizes that discretionary orders raise novel issues under the Quote Rule, the Commission does not believe that it would be in the best interests of the national market system or the protection of investors to prohibit the use of discretionary orders on ArcaEx. In the Commission's view, discretionary orders may represent a positive development for equities trading in an electronic exchange environment. The Commission believes that the discretionary order type, for example, might enable an institution to express its trading interest more fully than otherwise would be the case, in a single order covering multiple prices. This in turn could give other investors, both individual and institutional, an opportunity to interact more easily with such orders. In this regard, discretionary orders may give retail investors access to price improvement that previously has not been available in automated trading systems.<sup>89</sup>

<sup>87</sup> The Commission solicited comments as to whether discretionary orders on ArcaEx are consistent with the Quote Rule. Nasdaq opposed discretionary orders but provided no analysis to support the position.

<sup>88</sup> See Securities Exchange Act Release No. 39086 (September 17, 1997), 62 FR 50036 (September 23, 1997). The Commission does not believe that the undisplayed prices of discretionary orders can properly be characterized as "indications of interest." Unlike OptiMark Profiles, the undisplayed portion of a discretionary order would depend upon a publicly displayed price to establish its priority and standing within the ArcaEx system. Moreover, as the rules of the ArcaEx facility require both the displayed and the undisplayed portions of discretionary orders to be firm, a compatible incoming limit order would be automatically executed against the discretionary price imbedded in a discretionary order.

<sup>89</sup> The Commission notes that the ATS Release recognized the value of conditional orders, and expressly allowed ATSs to continue using reserve

In addition, one of the Commission's goals is to encourage "the deepest, most liquid markets possible."<sup>90</sup> In the Commission's view, by providing investors with greater flexibility in the expression of their trading interest, discretionary orders may encourage greater investor participation on the PCX, which, in turn, may increase the depth and liquidity of the securities markets.<sup>91</sup>

The Commission notes, moreover, that near equivalents to discretionary orders already exist on our national exchanges. For example, specialists at the New York Stock Exchange ("NYSE") routinely accept "percentage orders," in which the specialist follows instructions to match bids and offers up to a described limit but ordinarily does not display that limit, and floor brokers on the NYSE work orders with varying degrees of discretion that may be partially converted to displayed bids or offers within an allowed range.<sup>92</sup> In short, the functional equivalents of discretionary orders are being employed at other national securities exchanges today.

After carefully considering the advantages and disadvantages of discretionary orders, the Commission has concluded that discretionary orders are consistent with the Quote Rule. Because discretionary orders as applied on ArcaEx would represent a novel order type, however, the Commission believes that it would be useful to monitor their application in a live trading environment. The PCX has agreed to provide specific information to the Commission's staff with respect to the use of discretionary orders, including their impact on the execution of market orders in the Arca Book. Specifically, the PCX has agreed to

size orders, negotiation features, and other similar conditional orders. See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844, 70866 (December 22, 1998).

<sup>90</sup> Securities Exchange Act Release No. 43084 (July 28, 2000), 65 FR 48406, 48407 (August 8, 2000) ("Disclosure of Order Routing and Execution Practices").

<sup>91</sup> Cf. Securities Exchange Act Release No. 42344 (January 14, 2000), 65 FR 3987, 3995 (January 25, 2000) (stating that increased participation in the Nasdaq National Market Execution System, as a result of the attractiveness of reserve orders for large investors, should enhance the depth and liquidity of the market for Nasdaq National Market securities to the benefit of all market participants).

<sup>92</sup> Discretionary orders may also resemble certain trading practices on regional exchanges, where regional specialists display one set of quotes while guaranteeing their customers more favorable order executions at the NBBO or better, which they do not display. See, e.g., CHX Rule 37(a). The Commission historically has not determined that the order guarantees of regional specialists violate the Quote Rule.

<sup>83</sup> Nasdaq Letter 2 at p.11.

<sup>84</sup> Subsection (a)(21)(i) of the Quote Rule defines the term "responsible broker or dealer" to mean: "When used with respect to bids or offers communicated on an exchange, any member of such exchange who communicates to another member on such exchange, at the location (or locations) designated by such exchange for trading in a covered security, a bid or offer for such covered security, as either principal or agent \* \* \* Rule 11Ac1-1(a)(21)(i).

<sup>85</sup> Rule 11Ac1-1(c).

<sup>86</sup> Rule 11Ac1-1(a)(4) (emphasis added).

submit data with respect to the following:

- The manner and frequency with which PCX market makers and other users are employing discretionary orders on ArcaEx;
- The extent to which market makers are using discretionary orders when trading for their own accounts;
- The quality of execution of discretionary orders (e.g., inside the quote); and
- The volume of trading attributed to discretionary orders.

This information will enable the Commission's Division of Market Regulation, Office of Economic Analysis, and Office of Compliance Inspections and Examinations to evaluate the practical effects of discretionary orders as applied on ArcaEx.

#### D. Section 11(a) of the Act

Section 11(a) prohibits a member of a national securities exchange from effecting transactions on that exchange for its own account, the account of an associated person, or an account over which it or its associated person exercises discretion (collectively, covered accounts) unless an exemption applies.<sup>93</sup> The purpose of this section was to encourage fair dealing and fair access in the exchange markets by reducing the conflicts arising from an exchange member trading for its own account in the public exchange markets.<sup>94</sup>

To supplement the exemptions in the statute, the Commission has adopted several rules that provide specific exemptions for transactions that would otherwise be prohibited by section 11(a). For example, Rule 11a1-1(T) provides that a member's proprietary order may be executed on the exchange to which the member belongs, as long as (1) the member discloses to the broker employed and to the trading floor that the order is proprietary,<sup>95</sup> and (2) any

<sup>93</sup> 15 U.S.C. 78k(a). In addition to the exemptions contained in Section 11(a) of the Act, the Commission has adopted rules under this Section to provide additional exemptions. *See* 17 CFR 240.11a-1 (regulation of floor trading); 17 CFR 240.11a1-1(T) (transactions yielding priority, parity, and precedence); 17 CFR 240.11a1-2 (transactions for certain accounts of associated persons of members); 17 CFR 240.11a1-3(T) (bona fide hedge transactions in certain securities); 17 CFR 240.11a1-4(T) (bond transactions on national securities exchanges); 17 CFR 240.11a1-5 (transactions by registered competitive market makers and registered equity market makers); 17 CFR 240.11a1-6 (transactions for certain accounts of OTC derivatives); and 17 CFR 240.11a2-2(T) (transactions effected by exchange members through other members).

<sup>94</sup> *See* 78 Cong. Rec. 2270-71 (1934).

<sup>95</sup> Specifically, Rule 11a1-1(T)(a)(1) provides that the member must disclose that the order is

member presenting a proprietary order on the exchange floor yields priority to any bid or offer at the same price that is not also a proprietary order, notwithstanding any otherwise applicable rules of priority, parity, and precedence.<sup>96</sup> In addition, Rule 11a2-2(T) permits an exchange member to effect transactions for covered accounts if, among other things, the member uses an independent floor broker to execute the transactions on the exchange floor.<sup>97</sup> In particular, a member relying on Rule 11a2-2(T): (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. The purpose of these requirements is "to put members and non-members on the same footing, to the extent practicable, in light of the purposes of section 11(a)."<sup>99</sup>

As noted above, the Phlx asserted that the operation of ArcaEx would be inconsistent with the requirements of section 11(a) because members' proprietary orders would not yield priority to public customer orders. In

proprietary to any member with whom the order is placed or to whom the order is communicated, and members with whom such an order is placed or communicated must disclose the proprietary status of the order to others participating in effecting the order. Rule 11a1-1(T)(a)(2) provides that immediately before executing a proprietary order, a member (other than the specialist in the security being traded) presenting such an order must "clearly announce or otherwise indicate" to the specialist and to any other members then present for trading in that security, that the order is proprietary.

<sup>96</sup> Proprietary orders must yield to non-proprietary orders at the same price, regardless of the size of the orders or the time at which they are entered. *See* Rule 11a1-1(T)(a)(3), 17 CFR 240.11a1-1(T)(a)(3).

<sup>97</sup> *See* Rule 11a2-2(T)(a)(2), 17 CFR 240.11a2-2(T)(a)(2). *See also* Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11542 (March 17, 1978) (orders that are cancelled or changed under this rule are treated as new orders; such instructions must also be transmitted to the executing broker from off the floor); Securities Exchange Act Release No. 14713 (April 28, 1978), 43 FR 18557 (May 1, 1978) (orders must be transmitted directly to the executing broker from off the floor; they can not be sent through the initiating member's floor employees).

<sup>98</sup> The member may participate, however, in clearing and settling the transaction.

<sup>99</sup> Securities Exchange Act Release No. 14713 (April 28, 1978), 43 FR 18557 (May 1, 1978).

response to this comment, the PCX explained that ArcaEx is not relying on the exemption provided by Rule 11a1-1(T), but rather is relying on Rule 11a2-2(T). As the PCX explained, "the order execution algorithm of ArcaEx complies with the formal requirements of, and satisfies the policy concerns underlying, section 11(a) without requiring public customer priority."<sup>100</sup>

In particular, the PCX explained that all users, including exchange members, would transmit their orders electronically directly to ArcaEx from remote terminals. Once an order has been transmitted, a user could not further control or influence the order's execution. The orders enter a line of other orders to be executed against each other in the Arca Book based on an established matching algorithm. Execution depends on what orders are entered into ArcaEx at the same time, what orders are already in the Arca Book, and how the orders are ranked based on the time-price ranking algorithm.<sup>101</sup>

This electronic order and execution process of ArcaEx satisfies the four criteria of Rule 11a2-2(T). First, all orders are electronically submitted through remote terminals from off the exchange floor. Second, because a member relinquishes control of its order after transmission to ArcaEx, it receives no special or unique trading advantages. Third, although the rule contemplates having an order executed by an exchange member who is unaffiliated with the member initiating the order, the Commission recognizes that this requirement is not applicable when automated exchange facilities are used.<sup>102</sup> Fourth, ArcaEx members trading for covered accounts will disclose discretionary account compensation, as required by the rule. The Commission and its staff have, on numerous occasions, considered the application of Rule 11a2-2(T) to electronic trading and order routing

<sup>100</sup> *See* PCX Response 1 at p. 12.

<sup>101</sup> The Commission notes that proposed PCXE Rule 6.16 would prohibit ETP Holders from trading ahead of customer limit orders.

<sup>102</sup> For example, in considering the operation of automated execution systems operated by an exchange, 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. 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). *See* Securities Exchange Act Release No. 15533 (January 29, 1979).

systems.<sup>103</sup> The PCX requested guidance from the staff regarding PCX's interpretation of how ArcaEx meets the requirements of Rule 11a-2-2(T), and the staff concurred with PCX's interpretation.<sup>104</sup> The Commission finds that the proposed operation of ArcaEx is consistent with section 11(a) of the Act.

#### E. The Wave Broker-Dealer

##### 1. The Proposed Functions of Wave

Wave, a wholly owned subsidiary of Archipelago Holdings LLC, is a registered broker-dealer and a member of the NASD. The PCX described Wave's three functions with respect to ArcaEx in Amendment No. 3 to the proposed rule change.

First, Wave would register as an ETP Holder and act as an introducing broker for customers that are non-ETP Holders. In that capacity, Wave would provide sponsored access to ArcaEx pursuant to contractual relationships with entities that are not ETP Holders.

Second, Wave would provide an optional routing service for ArcaEx, and, as necessary, would route orders to other market centers from ArcaEx.<sup>105</sup> Those who choose to use this service would sign a Wave Routing Agreement that reads, in pertinent part:

User agrees that all orders on its behalf must be transmitted to WAVE through the Archipelago Exchange. User agrees that the Archipelago Exchange is its exclusive mechanism for purposes of transmitting orders on its behalf to WAVE and for receiving notice regarding such orders. WAVE shall be entitled to rely upon and act in accordance with any order instructions received from the Archipelago Exchange on behalf of User. User agrees that all order executions effected on behalf of User

<sup>103</sup> See, e.g., Securities Exchange Act Release No. 29237 (May 31, 1991) (regarding NYSE's Off-Hours Trading Facility); Securities Exchange Act Release No. 15533 (January 29, 1979) (regarding the Amex Post Execution Reporting System, the Amex Switching System, the Intermarket Trading System, the Multiple Dealer Trading Facility of the Cincinnati Stock Exchange, the PCX's Communications and Execution System, and the Phlx's Automated Communications and Execution System); Securities Exchange Act Release No. 14563 (March 14, 1978) (regarding the NYSE's Designated Order Turnaround System). See also Letter from Larry E. Bergmann, Senior Associate Director, Division of Market Regulation, SEC, to Edith Hallahan, Associate General Counsel, Phlx (March 24, 1999) (regarding Phlx's VWAP Trading System); Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to David E. Rosedahl, PCX (November 30, 1998) (regarding OptiMark); and Letter from Brandon Becker, Director, Division of Market Regulation, SEC, to George T. Simon, Foley & Lardner (November 30, 1994) (regarding Chicago Match).

<sup>104</sup> Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, to Kathryn Beck, Senior Vice President and Special Counsel, PCX, dated October 25, 2001.

<sup>105</sup> See, e.g., proposed PCXE Rules 1.1(gg), 7.32 and 7.37(d).

pursuant to this agreement shall be reported by WAVE to the Archipelago Exchange. The User shall be notified of such executions through the Archipelago Exchange.<sup>106</sup>

In addition, the Wave routing agreement provides that orders routed through Wave will remain subject to the rules of PCXE.<sup>107</sup>

Third, Wave would continue to operate an ECN. Wave's ECN would trade only those securities that are ineligible for unlisted trading privileges on ArcaEx. As proposed, Wave's ECN would continue to trade the securities that are ineligible for unlisted trading on ArcaEx, but it would cease trading those securities if they became eligible.<sup>108</sup>

##### 2. ArcaEx's Affiliation with Wave

As noted above, Archipelago Holdings LLC would own both ArcaEx, a facility of the PCX, and Wave, a broker-dealer. Nasdaq and Knight expressed concerns regarding ArcaEx's affiliation with the Wave broker-dealer operating in the capacities described above. Specifically, in their comment letters, Nasdaq and Knight contended that the proposed market structure of ArcaEx, particularly the relationship between ArcaEx and Wave, would be anti-competitive.<sup>109</sup> Nasdaq believes that Wave's order routing mechanism, combined with its role as an introducing broker and its maintenance of an ECN for trading Nasdaq securities, would create a troubling conflict of interest and would result in a competitive imbalance between Wave and other ETP Holders. Similarly, Knight believes that the proposal does not adequately address Wave's potential conflict as a broker-dealer and an order-routing mechanism for ArcaEx.

Under section 6 of the Act, the rules of a national securities exchange must not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.<sup>110</sup> The Commission recognizes that the potential for unfair discrimination may be heightened if a national securities exchange or its affiliate owns or operates a broker dealer. This is because

<sup>106</sup> See Wave Routing Agreement, <http://www.tradearpa.com/exchange>, visited on October 14, 2001.

<sup>107</sup> Id. ("User understands and agrees that orders executed on its behalf shall at all times be subject to the terms and conditions of the PCXE Rules.")

<sup>108</sup> Unlisted trading privileges of Nasdaq securities on national securities exchanges are subject to the OTC-UTP Plan and Section 12(f) of the Act. Currently, 1,000 Nasdaq National Market issues may be admitted to unlisted trading privileges on national securities exchanges.

<sup>109</sup> See Nasdaq Letters 2 and 3; Knight Letters 1 and 2.

<sup>110</sup> See Section 6(b)(5) of the Act, 15 U.S.C. 78f(b)(5).

the financial interests of the national securities exchange may conflict with its responsibilities as an SRO regarding the affiliated broker-dealer. For this reason, the national securities exchange must not serve as the self-regulatory organization that is primarily responsible for examining its affiliated broker-dealer.<sup>111</sup> Moreover, a conflict of interest would arise if the national securities exchange (or an affiliate) provided advantages to its broker-dealer that are not available to other members, or provided a feature to all members that was designed to give its broker-dealer a special advantage. These advantages, such as greater access to information, improved speed of execution, or enhanced operational capabilities in dealing with the exchange, might constitute unfair discrimination under the Act. The Commission has considered these potentially unfair advantages in the light of Wave's proposed functions.

##### a. The PCX Application of the Wave Order-Routing Function

Both Nasdaq and Knight believe that users who do not choose to enter into a routing agreement, and therefore do not use the order routing services of Wave, would be placed at a competitive disadvantage *vis a vis* users who opt to enter into a routing agreement. Moreover, Knight suggested that Wave would violate the fair access provisions of the Act because certain order types would not be available to those who have chosen not to use Wave. Finally, Nasdaq suggested that, because ArcaEx would have to return the partially executed or unexecuted orders to non-users of Wave, who would then route the orders by alternative means, the price and speed of execution for such orders could be significantly compromised.

The PCX addressed Wave's role as an optional order routing mechanism of the PCX in considerable detail. First, the PCX asserted its view that no denial of access issues arise with respect to any order type, regardless of their routing mechanism, because every user must satisfy identical, objective requirements for submitting each order type.<sup>112</sup> In the PCX's view, as the requirements do not vary based on the identity of the user, the routing procedures and mechanisms

<sup>111</sup> See ATS Release, 63 FR at 70892. Indeed, as the Commission noted in the ATS Release, a national securities exchange that operates a broker-dealer/alternative trading system must arrange for another SRO to act as the regulator for that entity. Here, the NASD will be the designated examining authority for those functions of Wave that are not facilities of the PCX.

<sup>112</sup> See PCX Response 2 and 3.

do not unfairly discriminate against any particular class of user.<sup>113</sup>

Second, the PCX noted that, although users could opt to route orders from ArcaEx to other market centers through the Wave order routing function, no ArcaEx user would be required to use Wave for this purpose.<sup>114</sup> Members could also select other broker-dealers to provide order-routing functions. Under the PCX's proposal, if a user has not chosen to use Wave's routing services, the user's unexecuted or partially unexecuted order would be returned to the user or its designated agent after a sweep of the ArcaEx market.<sup>115</sup> Once the order is returned, the user would then be able to route it to another market center by an alternative means. As an example, the PCX pointed out that a user could opt to bypass Wave entirely and instead rely on its own routing abilities or those of another broker-dealer by using a "fill or return" or a "fill or return plus" order.<sup>116</sup> By using those orders, a user could route its order to another market in a manner of its own choosing if the order is not fully executed on the ArcaEx.

Third, the PCX emphasized that users who opt out of the Wave routing services would be precluded from entering only a very limited subset of orders that specifically incorporate a Wave routing requirement within the definition of the order. In particular, non-users of Wave would be unable to enter only a primary-only order (an order that is automatically routed to the primary market as a market-on-open order) and a NOW order (an order that is automatically routed to a different market center for immediate execution).<sup>117</sup> In handling these particular orders, which are executed solely on another market, Wave does not have advantages from its ArcaEx function. The PCX also represented that information barriers would be maintained to ensure that Wave does not unfairly take advantage of

<sup>113</sup> See, e.g., Section 6(b)(5) of the Act (the rules of an exchange may not be designed to permit "unfair discrimination").

<sup>114</sup> See, e.g., proposed PCXE Rules 1.1(gg), 7.32 and 7.37(d). The PCX explained the PCX and Archipelago opted to employ the services of a routing broker (rather than to rely on routing orders to other markets directly from PCX itself) simply because of various technical issues associated with market center-to-market center routing.

<sup>115</sup> 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).

<sup>116</sup> See proposed PCXE Rules 7.31(p) and 7.31(r) (definitions of "fill or return" and "fill or return plus" orders, respectively).

<sup>117</sup> See proposed PCXE Rule 7.31(v) and (x) (definitions of "NOW" and "primary only" orders, respectively).

knowledge gained as the PCX's order routing mechanism.

The Commission believes that, although Wave's routing services are optional, Wave's order-routing function occupies a special position with respect to ArcaEx. In the Commission's view, Wave is uniquely linked to and endorsed by ArcaEx to provide its outbound routing functionality. Therefore, the Commission believes, and the PCX agrees, that the PCX application of the Wave order-routing function falls within the definition of a facility under the Act. Section 3(a)(2) of the Act provides:

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 use of such premises or property or any service thereof *for the purpose of effecting or reporting a transaction on the 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.* (Emphasis added.)

In the Commission's view, by functioning as an order routing mechanism for ArcaEx, Wave would operate as a "system of communication" to or from the PCX for the purpose of effecting a transaction on the exchange. Specifically, pursuant to contract, Wave would receive instructions from ArcaEx, would route orders away in accordance with those instructions, and would be responsible for reporting resulting executions back to ArcaEx.<sup>118</sup> In addition, as discussed above, all orders routed through Wave would remain subject to the terms and conditions of the PCX's rules.<sup>119</sup>

Because the application of the Wave order routing function is a facility of the PCX, the PCX would be responsible for regulating the Wave order routing function as an exchange facility subject to section 6 of the Act. As such, Wave's order routing function would be subject to the Commission's continuing oversight. In particular, under the Act, the PCX must file rule changes and fees relating to the Wave order-routing function, and Wave would be subject to exchange non-discrimination requirements.<sup>120</sup> These requirements are intended to address the potential misuse

<sup>118</sup> These trades would be reported by the executing market.

<sup>119</sup> See Wave Routing Agreement, <http://www.tradearpa.com/exchange>, visited on October 14, 2001.

<sup>120</sup> See, e.g., Section 6(b)(5) of the Act, 15 U.S.C. 78f(b)(5).

of advantages that might arise from Wave's order-routing function.<sup>121</sup>

#### b. Wave's Function as Introducing Broker for ArcaEx

The PCX's indirect ownership of Wave, combined with Wave's role as an introducing broker to ArcaEx, raises the question whether Wave in this role should be considered a facility of the PCX. Despite Wave's affiliation with the PCX, the Commission does not believe that Wave's introducing broker function should necessarily be viewed as constituting a facility of the PCX.<sup>122</sup> In its introducing broker role, Wave would be acting as a user/member of the ArcaEx on precisely the same terms as any other member. Wave would not be the sole source of sponsored access to ArcaEx; all other ETP Holders could readily provide similar services on behalf of their customers. In addition, the PCX is subject to existing statutory standards that prohibit denials of access and other unfair discrimination against any member regarding access to the PCX's services. Those standards would preclude the PCX from providing Wave with unfair, preferential access to its facilities.

Furthermore, the PCX has provided additional protections to limit the risk that Wave would receive an unfair advantage over other ETP Holders in operating as an introducing broker. The PCX has instituted safeguards to ensure that Wave's introducing broker function would be segregated from the operation of the PCX and its facilities, so that Wave would not receive any informational advantages from its affiliation with ArcaEx and the PCX. Specifically, proposed PCXE Rule 14 requires the PCX to maintain strong information barriers between its facilities and other functions of the Wave broker-dealer.<sup>123</sup>

The Commission believes that the availability of sponsored access to ArcaEx from multiple sources, coupled with the segregation of functions described above, would adequately protect investors and the public interest from potential concerns arising from the

<sup>121</sup> The Commission also believes that, because Wave's order-routing function is optional and because those who decline to use it would continue to have full access to the rest of the ArcaEx facility, the Wave order-routing function would not be per se unfairly discriminatory.

<sup>122</sup> Cf. Securities Exchange Act Release No. 44201 (April 18, 2001), 66 FR 21025 (April 26, 2001) (Certain aspects of OTC Tools software application providing enhanced access to Nasdaq functionality, which was owned and exclusively available through the NASD was considered a facility of the NASD).

<sup>123</sup> See Amendment No. 5 to the proposed rule change.

PCX's affiliation with Wave. This analysis would change, however, should Wave become the sole or predominant source of sponsored access to ArcaEx, or should the PCX's information barriers prove to be ineffective. In that case, the potential advantages provided to Wave in its operation as an introducing broker from its affiliation with the PCX may cause Wave to be considered a facility of the PCX and therefore subject to the requirements of section 6 of the Act.

#### c. Wave's Operation of an ECN

As noted above, Nasdaq expressed the view that Wave's ECN should be regulated as a facility of the PCX. The PCX submitted a response in which it argued that Wave's ECN does not meet the definition of a facility under section 3(a)(2) of the Act. The PCX noted that Wave's ECN would perform a very limited trading function, serving as an ECN for only those Nasdaq securities that are not eligible for trading on ArcaEx.

In the ATS Release, the Commission stated that exchanges may "form subsidiaries or affiliates that operate alternative trading systems registered as broker-dealers."<sup>124</sup> Such subsidiaries or affiliates are required to become members of a national securities association or national securities exchange. Furthermore, the alternative trading system would be considered a facility of its affiliated exchange if it were integrated or otherwise linked to that exchange.

Here, Wave's ECN will continue to be regulated by the NASD rather than the PCX,<sup>125</sup> will trade only those Nasdaq securities that are not eligible for trading on the PCX, and will not be integrated or otherwise linked to the PCX. In addition, the PCX has represented that once all Nasdaq securities are eligible for trading on the PCX, the Wave ECN will cease operation completely. In view of the foregoing, the Commission believes that the Wave ECN is not a facility of the PCX, and that it is properly regulated within the framework that Regulation ATS establishes.

#### V. Commission's Findings

On the basis of the facts and conclusions discussed in Sections I through IV above, the Commission makes the following findings with respect to the PCX's proposal.

<sup>124</sup> See ATS Release, 63 FR at 70891.

<sup>125</sup> See PCX Response 2 and 3.

#### A. Competition, Efficiency, and Capital Formation

In reviewing the PCX's proposal, the Commission is required under section 3(f) of the Act<sup>126</sup> to consider whether the proposal will promote competition, efficiency, and capital formation. In addition, section 6(b)(8) requires that the rules of an exchange not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.<sup>127</sup>

As noted above, in the Commission's view, the proposed ArcaEx facility would provide a new and technologically advanced way for trading interest to be matched and orders to be executed on the PCX. If the ArcaEx facility is able to attract new market participants and to increase order flow to the PCX, the facility could promote greater competition among market centers. In particular, ArcaEx's trading rules are designed to encourage the use of various tools, such as discretionary orders and reserve size, that will allow investors greater flexibility in displaying and managing their orders, thereby allowing them to more fully represent their trading interest in a public marketplace. Thus, the Commission believes that the PCX's proposal does not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

Moreover, if the ArcaEx facility succeeds in attracting more order flow to the PCX, the PCX may begin to serve as a greater source of liquidity for investors, and this in turn could promote greater efficiency of executions. Similarly, the availability of novel features will provide investors and issuers with new opportunities to interact, thereby encouraging capital formation.

#### B. Section 6(b)(5) of the Act

The Commission finds that the PCX's proposed rules establishing the ArcaEx as its facility are consistent with section 6(b)(5) of the Act,<sup>128</sup> in that the rules have been designed to remove impediments to and to perfect the mechanism of a free and open market and a national market system, while also protecting investors and the public interest. Specifically, the PCX's rule proposal would create a new electronic platform for matching and executing orders. Significant features of the ArcaEx facility (as reflected in the PCX rules), such as the availability, in real time, of the entire displayed book via

<sup>126</sup> 15 U.S.C. 78c(f).

<sup>127</sup> 15 U.S.C. 78f(b)(8).

<sup>128</sup> 15 U.S.C. 78f(b)(5).

the internet, would provide investors with more timely and accurate information regarding trading interest on the facility. In addition, the use of discretionary orders on ArcaEx may provide investors with greater flexibility to represent their trading interest accurately and completely. Further, the order routing function and the ITS connection would also provide investors entering orders into ArcaEx with the ability to access the best prices in different markets should their order not be executable on the Arca Book.

In addition, the Commission finds that the PCX's proposal is consistent with the requirements of section 6(b)(5) that the rules of an exchange be designed to prevent fraudulent and manipulative acts and to promote just and equitable principles of trade, and that they not be designed to permit unfair discrimination among customers, issuers, or broker-dealers. Specifically, the PCX has, when necessary and appropriate, adapted its customer protection rules to reflect its adoption of the all-electronic ArcaEx trading facility.<sup>129</sup> The PCX has also committed to develop and maintain an appropriate system of surveillance and an audit trail. Finally, by rule, the PCX has proposed to segregate the functions of the ArcaEx facility and the functions of Wave that are not regulated as facilities of the PCX. Accordingly, the Commission does not believe that the PCX's rules permit unfair discrimination among users of ArcaEx.

#### C. Section 11A of the Act

In section 11A(a)(1)(C),<sup>130</sup> Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure: (1) The economically efficient execution of securities transactions; (2) fair competition among brokers and dealers; (3) the availability to brokers, dealers, and investors of information with respect to quotations and transactions in securities; (4) the practicability of brokers executing investors' orders in the best market; and (5) an opportunity for investors' orders to be executed without the participation of a dealer. Congress also recognized that technology would drive competition among the securities markets, stating, "[n]ew data processing and communications techniques create the opportunity for more efficient and

<sup>129</sup> See, e.g., proposed PCX Rule 6.16 (prohibiting members from trading ahead of customer limit orders).

<sup>130</sup> 15 U.S.C. 78k-1(a)(1)(C).

effective market operations.”<sup>131</sup> Congress instructed the Commission to seek to “enhance competition and to allow economic forces, interacting with a fair regulatory field, to arrive at appropriate variation in practices and services.”<sup>132</sup>

The Commission believes that the proposal incorporates features that will provide investors with the opportunity to receive economically efficient execution of their securities transactions and to promote fair and orderly markets.<sup>133</sup> In addition to the features noted above, the Commission notes that a significant feature of the Arca Book is that it potentially provides an opportunity for investors’ orders to be executed without the participation of a market maker. The Commission also believes that the real-time dissemination of the Arca Book to the public via the internet will provide valuable information to all market participants and is reasonably designed to promote price discovery. Finally, the Commission believes that ArcaEx’s routing technology and link to ITS will allow investor orders efficiently to reach other markets with better prices. Therefore, Commission finds that the PCX’s proposal is consistent with section 11A of the Act.

## VI. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment Nos. 4 and 5, including whether Amendment Nos. 4 and 5 are 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 Nos. 4 and 5 of File No. SR-PCX-2000-

25 and should be submitted by November 23, 2001.

## VII. Order Granting Approval

The original rule proposal was noticed for public comment in November 2000. Amendment No. 4 makes technical corrections to the rules and adds a provision with respect to the status of the books and records of Archipelago Holdings LLC. Amendment No. 5 is directly responsive to questions raised by commenters regarding the status of Wave. The Commission believes that it has received and fully considered substantial, meaningful comments with respect to the PCX’s proposal, as amended, and that Amendment Nos. 4 and 5 do not raise issues that warrant further delay.<sup>134</sup> Accordingly, pursuant to section 19(b)(2) of the Act,<sup>135</sup> the Commission finds good cause to approve Amendment Nos. 4 and 5 prior to the thirtieth day after notice of the Amendments is published in the **Federal Register**.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>136</sup> that Amendment Nos. 4 and 5 to the PCX’s proposed rule change are hereby granted accelerated approval; and

*It is also ordered*, pursuant to section 19(b)(2) of the Act,<sup>137</sup> that the proposed rule change (File No. SR-PCX-00-25), as amended, is hereby approved.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 01-27417 Filed 10-31-01; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34-44991; File No. SR-PHLX-2001-74]**

### Self-Regulatory Organizations; Order Approving Proposed Rule Change by the Philadelphia Stock Exchange, Inc. To Amend Phlx By-Law Article XII, Section 12-4 and Article XV, Sections 15-1 and 15-2

October 26, 2001.

On August 7, 2001, the Philadelphia Stock Exchange, Inc. (“Phlx” or “Exchange”) submitted to the Securities and Exchange Commission (“Commission”), pursuant to section 19(b)(1) of the Securities Exchange Act

of 1934 (“Act”),<sup>1</sup> and rule 19b-4 thereunder,<sup>2</sup> a proposed rule change that would: (i) Amend Phlx By-Law Article XII, section 12-4 and Article XV sections 15-1 and 15-2 to reduce the current 14-day posting period for membership and foreign currency options participation transfers to seven days,<sup>3</sup> (ii) change the notice of posting from the Exchange bulletin board to the Phlx website while retaining publication in the Secretary’s Weekly Bulletin; and (iii) allow the Chairman or his designate to reduce the posting period as deemed appropriate upon determination that such action is in the best interests of the Exchange. The **Federal Register** published the proposed rule change for comment on September 26, 2001.<sup>4</sup> The Commission received no comments on the proposal.

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 exchange<sup>5</sup> and, in particular, the requirements of section 6 of the Act<sup>6</sup> and the rules and regulations thereunder. The Commission finds that the proposed rule change is consistent with section 6(b)(5) of the Act<sup>7</sup> and believes that the proposed rules should continue to provide members with sufficient notice of proposed transfers of memberships or foreign currency options participations to allow for the submission of information concerning an applicant’s qualifications and fitness for membership. Therefore, the Commission finds the proposed rule change is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and,

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

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

<sup>3</sup> As required by Exchange By-Law Article, XXII, section 22-2, the Exchange issued notice of the proposed By-Law amendments to Articles XII and XV to its membership on April 11, 2001 and July 10, 2001, respectively. The Exchange represents that it did not receive a request from 17 or more members for a special meeting of the Exchange to consider the proposed amendment. As a result, the Board approved the proposed amendment to By-Law Article XII on May 16, 2001, and approved the proposed amendment to By-Law Article XV on August 1, 2001. Telephone conversation between Murray L. Ross, Vice President and Secretary, Phlx, Florence Harmon, Senior Special Counsel, Division of Market Regulation (“Division”) Commission, and Sonia Patton, Special Counsel, Division, Commission (September 13, 2001).

<sup>4</sup> Securities Exchange Act Release No. 44819 (September 19, 2001), 66 FR 49242.

<sup>5</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>6</sup> 15 U.S.C. 78f.

<sup>7</sup> 15 U.S.C. 78f(b)(5).

<sup>131</sup> *Id.*

<sup>132</sup> See S. Rep. No. 94-75, 94th Cong., 1st Sess. 7 (1975) at p. 8.

<sup>133</sup> 15 U.S.C. 78k-1.

<sup>134</sup> See also discussion at text accompanying note 76, *supra*.

<sup>135</sup> 15 U.S.C. 78s(b)(2).

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*