



SECURITIES AND EXCHANGE COMMISSION
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VIA FACSIMILE AND EXPRESS MAIL

DIVISION OF MARKET REGULATION

December 28, 2004

Ms. Annette L. Nazareth, Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Subpenny Trading Increments

Dear Ms. Nazareth:

On July 30, 1997, the Division of Market Regulation ("Division") of the Securities and Exchange Commission ("Commission") issued a no-action letter to the Nasdaq Stock Market, Inc. that allowed Nasdaq market makers to publicly disseminate bids and offers rounded to the narrowest applicable quotation increment used by Nasdaq systems, even though those market makers might actually be quoting and trading in increments smaller than the ones that were publicly reported.¹ In addition, on April 6, 2001, the Commission granted the Chicago Stock Exchange, Inc. ("CHX") exemptive relief for subpenny trading in Nasdaq National Market ("NNM") securities, and later granted similar exemptive relief to the National Stock Exchange, Inc. ("NSX", formerly the Cincinnati Stock Exchange, Inc.) for subpenny trading in NNM and Small Cap securities.²

On September 25, 2002, the Commission granted the NSX another exemption that extended and expanded upon its previous exemption to allow NSX (and its members and vendors) to disseminate quote information and display their quotes for exchange-listed

¹ In the July, 1997 letter, the Commission recognized that electronic communications networks ("ECNs") might have rules that allowed acceptance of orders priced in increments smaller than those permitted by Nasdaq or other self-regulatory organizations. Under the Quote Rule, Nasdaq market makers are allowed to submit these smaller increment orders to ECNs, so long as the ECN displays the quotes, rounded up (for orders to sell) or down (for orders to buy), with a rounding indicator. The no-action relief permitted the display of these rounded quotes without the rounding indicator. See Letter to Robert Aber, Vice President and General Counsel, Nasdaq, from Richard Lindsey, Director, Division of Market Regulation, Commission, dated July 30, 1997.

² See Letters to Paul O'Kelly, CHX, from Annette L. Nazareth, Director, Division of Market Regulation, Commission, dated April 6, 2001 and Jeffrey T. Brown, General Counsel, NSX, from Annette L. Nazareth, Director, Division of Market Regulation, Commission, dated July 26, 2002.

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securities, as well as NNM securities and Small Cap securities, in rounded penny increments while trading in subpenny increments.³ Through this letter, the Pacific Exchange, Inc. ("PCX" or "Exchange"), through its wholly owned subsidiary PCX Equities, Inc. ("PCXE"), is requesting similar exemptive relief. The PCXE requests through June 30, 2005, an exemption to permit ETP Holders of the Archipelago Exchange ("ArcaEx" a facility of the PCX) to provide for order entry and trading of certain securities traded on ArcaEx (NNM securities, Small Cap Securities, and exchange-listed securities) to be entered, executed and reported in increments of less than \$0.01, while vendors that disseminate ArcaEx quotation information report and disseminate quotes for those securities in penny increments.

Rules 11Ac1-1 (the "Quote Rule"), 11Ac1-2 (the "Vendor Display Rule") and 11Ac1-4 (the "Limit Order Display Rule") require exchanges, their members and quotation vendors to publicly disseminate certain bids and offers and sale information. Among other things, the Quote Rule requires exchange members to give their exchanges, and exchanges to give to quotation vendors, the best bids, best offers, quotation sizes for each security traded on that exchange. The Vendor Display Rule requires quotation vendors to display the best bids, best offers, quotation sizes and last sale information for their subject securities on their interrogation devices. The Limit Order Display Rule requires the display of certain customer limit orders when those orders are priced better than an exchange specialist's quote, or when the limit order adds to the size associated with the quote, if that quote is at the national best bid or offer. Currently on ArcaEx, its ETP Holders and quotation vendors disseminate bids, offers and last sale data, in penny increments.

The Exchange believes that allowing subpenny executions on ArcaEx in certain securities would afford ETP Holders with trading opportunities that are consistent with those available at competing exchanges such as NSX and CHX. Accordingly, pursuant to Rules 11Ac1-1(e), 11Ac1-2(g) and 11Ac1-4(d), the PCX requests that the Commission extend exemptive relief to ArcaEx and the vendors that disseminate ArcaEx quotation information, to allow the reporting and dissemination of ArcaEx quotes in penny increments even though these securities may be trading in increments smaller than a penny.⁴ Specifically, the PCX requests that the Commission grant relief to allow any subpenny quotes in securities to be rounded up (for orders to sell) or down (for orders to buy) to the nearest penny increment for public dissemination. The Exchange understands that any subpenny limit orders must be executed, in appropriate cases, at the non-rounded prices at which they are received. Executions at non-rounded prices will be reported at the execution price and will not be rounded for trade reporting purposes.

³ See Letter to Jeffrey T. Brown, General Counsel, NSX, from Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission, dated September 25, 2002.

⁴ The PCX believes that the Commission is authorized to grant the relief requested in the form of exemptive relief under Rules 11Ac1-1, 11Ac1-2 and 11Ac1-4. See Rules 11Ac1-1(e), 11Ac1-2(g) and 11Ac1-4(d) (authorizing exemptive relief when the Commission finds that it is consistent with the public interest, the protection of investors and the removal of impediments to, and perfection of, a national market system).

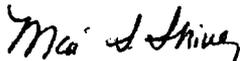
The Exchange further understands that the relief requested would extend until June 30, 2005 in order to permit the Exchange and the Commission to study data relating to orders and executions in subpenny increments. To advance the Commission's review, the Exchange agrees to provide the Commission with monthly reports on its activity in subpenny increments.⁵ Such information will include reported volume of orders received and executed in subpenny increments (in terms of both trades and shares), the execution price points, and the nature of the subpenny orders received and executed (*i.e.*, agency, principal, or otherwise).

In connection with this exemption request, the Exchange intends to seek the Commission's accelerated approval of a change to PCXE Rule 6.16 that governs trading ahead of customers' limit orders. The proposed rule change,⁶ would require that for securities trading in subpennies, the minimum amount of price improvement necessary to execute an incoming marketable order on a proprietary basis by an ArcaEx ETP Holder when holding an unexecuted customer limit order otherwise due an execution pursuant to PCXE Rule 6.16 in that same security is \$0.01.

The PCX believes that this relief is consistent with the public interest, the protection of investors and the removal of impediments to, and perfection of, the mechanism of a national market system. ECNs, Nasdaq market makers, NSX members, and CHX specialists are permitted to trade in increments finer than a penny, but disseminate rounded quotation information. By giving ArcaEx ETP Holders the same opportunity to trade in variations smaller than a penny, the Commission will advance the interests of the investing public whose orders may receive greater price improvement.

The Exchange respectfully requests an expedited consideration and approval of this request for relief. If you have any questions concerning this letter, please contact me at (415) 393-4266.

Sincerely



Mai S. Shiver
Director of Regulatory Policy
Pacific Exchange, Inc.

cc: Michael Gaw (SEC)
Alden Adkins (PCX)
Janet Angstadt (Archipelago)
Bridget Farrell (Archipelago)

⁵ Nasdaq, CHX, and NSX have agreed to provide the Commission with similar monthly reports.

⁶ See SR-PCX-2004-129.



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 24, 2004

VIA FACSIMILE AND U.S. MAIL

Mai S. Shiver
Director
Regulatory Policy
Pacific Exchange, Inc.
115 Sansome Street
San Francisco, California 94104

Re: Exemption for Display of Rounded Prices in Public Quotes for Securities
Priced Less than \$1.00

Dear Ms. Shiver:

In your letter dated September 15, 2004, on behalf of the Pacific Exchange, Inc. ("PCX" or "Exchange"), through its wholly-owned subsidiary PCX Equities, Inc. ("PCXE"), you requested that the Commission grant an exemption from Rules 11Ac1-1, 11Ac1-2, and 11Ac1-4 under the Securities Exchange Act of 1934 ("Act") to permit the Archipelago Exchange ("ArcaEx"), a facility of PCXE, and vendors that disseminate ArcaEx quotes to display their quotes for securities traded on ArcaEx (Nasdaq National Market, Small Cap, and exchange-listed securities) that are priced less than \$1.00 in penny increments, while ArcaEx ETP Holders and their customers may be trading in \$0.001 increments.

As you know, on August 28, 1997, the Commission adopted Rule 11Ac1-4 ("Limit Order Display Rule") and amendments to Rule 11Ac1-1 ("Quote Rule"). The Limit Order Display Rule requires the display of certain customer limit orders priced better than an over-the-counter ("OTC") market maker or specialist's quote, or when the limit order adds to the size associated with such quote if that quote is at the national best

bid or offer (“NBBO”).¹ In addition, the Quote Rule generally requires exchange members to give their exchanges, and exchanges to give to quotation vendors, the best bids, best offers and quotation sizes for securities traded on that exchange. Rule 11Ac1-2 (“Vendor Display Rule”) requires quotation vendors to disseminate best bids, offers, quotations sizes and last sale data for subject securities.

In a letter to the Nasdaq Stock Market (“Nasdaq”) dated July 30, 1997 (“Nasdaq Letter”), the Division of Market Regulation (“Division”) stated that, for any bid or offer supplied to the National Association of Securities Dealers (“NASD”) or Nasdaq, and rounded by Nasdaq to the appropriate minimum quotation increment, but disseminated without a rounding identifier, the Division would not recommend enforcement action to the Commission under Section 11A(c) of the Act, or Rules 11Ac1-1, 11Ac1-2, or 11Ac1-4 thereunder, with respect to the OTC market maker or Electronic Communications Network (“ECN”) supplying the rounded bid or offer or with respect to the NASD, Nasdaq, an exclusive securities information processor, and any quotation vendors publicly disseminating such bid or offer.² This letter permitted OTC market makers in Nasdaq securities to publicly disseminate bids and offers for those securities rounded to the narrowest applicable quotation increment used by Nasdaq systems, even though those market makers might actually be trading increments smaller than the ones being publicly reported.

Similarly, in letters to the Chicago Stock Exchange (“CHX”) and the National Stock Exchange (“NSX”), dated April 6, 2001 and July 26, 2002, respectively, the Division granted the CHX and the NSX temporary and conditional exemptions from Rules 11Ac1-1, 11Ac1-2, and 11Ac1-4 to allow these exchanges, their members, and the vendors that disseminate their quote information to display and disseminate their quotes for listed securities in rounded penny increments without a rounding identifier.³

Currently, ArcaEx, its ETP Holders and quotation vendors disseminate bids, offers, and last sale information in penny increments for those securities that have converted to decimal pricing (except with respect to Midpoint Cross Orders and Midpoint Directed Fills). In your letter dated September 15, 2004, you stated that ArcaEx wishes to accept and fill orders in Nasdaq National Market, Small Cap, and exchange-listed

¹ For a complete discussion of the amendments to the Quote Rule, see Securities Exchange Act Release No. 37169A (September 6, 1996), 61 FR 48290 (September 12, 1996).

² See Letter to Robert Aber, Vice President and General Counsel, Nasdaq, from Richard R. Lindsey, Director, Division, Commission, dated July 30, 1997.

³ See Letter to Paul O’Kelly, CHX, from Annette L. Narazeth, Director, Division, Commission (April 6, 2001) and Letter to Jeffrey T. Brown, Cincinnati Stock Exchange, from Robert L.D. Colby, Deputy Director, Division, Commission (July 26, 2002). The Commission has subsequently granted extensions to these temporary exemptions. For the most recent extensions, see Letters to James C. Yong, Senior Vice President, Regulation, and General Counsel, NSX, from David S. Shillman, Associate Director, Division, Commission, dated June 30, 2004 and Ellen J. Neely, Senior Vice President and General Counsel, CHX from David S. Shillman, Associate Director, Division, Commission, dated July 15, 2004.

securities that are priced less than \$1.00 in \$0.001 increments. The Exchange notes that ECNs, Nasdaq market makers, NSX market makers, and CHX market makers are permitted to trade in increments finer than a penny, but disseminate rounded quotation information.

You therefore request that the Commission exempt ArcaEx and its quotation vendors from Rules 11Ac1-1, 11Ac1-2, and 11Ac1-4 under the Act to allow the reporting and dissemination of ArcaEx quotes for securities priced less than \$1.00 in penny increments, even though ArcaEx ETP Holders and their customers may be trading in increments of \$0.001. Specifically, the Exchange requests that the Commission grant relief to allow sub-penny quotes in securities priced less than \$1.00 to be rounded up (for orders to sell) or down (for orders to buy) to the nearest penny increment for public dissemination. The Exchange has agreed that any sub-penny limit orders must be executed at the non-rounded prices at which they are received; executions at non-rounded prices will be reported at the execution price and will not be rounded for trade reporting purposes.

In addition, the Exchange believes that ArcaEx ETP Holders may have an unfair advantage if they are permitted to trade ahead of ArcaEx customer limit orders by improving upon the quoted price of such limit order by sub-penny increments. The Exchange filed with the Commission a proposed rule change (SR-PCX-2003-71) that would amend Exchange Rule 6.16, "Trading Ahead of Customer Limit Orders," to add language that will require an ArcaEx ETP Holder to better the price of a customer order by at least one penny (for those customer orders at the NBBO) if the ETP Holder determines to trade with an incoming market or marketable limit order.

To permit the Exchange and the Commission to study data relating to orders and executions in sub-penny increments, the Exchange has agreed that the requested relief would be granted on a pilot basis only, through September 30, 2005. The Exchange has agreed to provide the Commission's staff with information on a monthly basis, to allow the staff to monitor the effect of the pilot on trading at ArcaEx. Such information will include reported volume of orders received and executed in sub-penny increments (in terms of both trades and shares), the execution price points, and the nature of the sub-penny orders received and executed (*i.e.*, agency, proprietary, professional, or otherwise).

Response:

Based on the representations in your letter, and subject to the conditions stated above, the Commission finds that the requested exemption is consistent with the public interest, the protection of investors, and the removal of impediments to, and perfection of the mechanism of, a national market system. The Commission hereby grants the requested exemption from Rules 11Ac1-1, 11Ac1-2, and 11Ac1-4, to allow ArcaEx, ArcaEx ETP Holders and quotation vendors that disseminate ArcaEx quotation information to display and disseminate their quotes for securities priced less than \$1.00 in increments of \$0.001 without a rounding identifier. This exemption is expressly

contingent upon the Exchange's commitment to provide the staff of the Commission with monthly reports that include reported volume of orders received and executed in sub-penny increments (in terms of both trades and shares), the execution price points, and the nature of the sub-penny orders received and executed (*i.e.*, agency, proprietary, professional, or otherwise). Further, this exemption is temporary and will expire on September 30, 2005. However, depending on the action the Commission takes on proposed Regulation NMS prior to September 30, 2005, the Commission may determine to modify, withdraw, or extend the exemption.⁴

For the Commission, by the Division of Market
Regulation, pursuant to delegated authority,⁵



David S. Shillman
Associate Director

⁴ On February 24, 2004, the Commission proposed Regulation NMS for public comment. Securities Exchange Release No. 34-49325 (February 26, 2004), 69 FR 11126 (March 9, 2004). Proposed Rule 612 of Regulation NMS would, among other things, prohibit any national securities exchange, national securities association, alternative trading system, vendor, or broker or dealer from displaying, ranking, or accepting from any person a bid or offer, an order, or an indication of interest in any NMS stock price in an increment less than \$0.01, except for those NMS stocks the share price of which is below \$1.00. This exemption in no way prejudices or determines what actions the Commission may take with respect to any part of the Regulation NMS proposal.

⁵ 17 CFR 240.11Ac1-1(e), 17 CFR 200.30-3(a)(28); 17 CFR 240.11Ac1-2(g), 17 CFR 200.30-3(a)(36); 17 CFR 240.11Ac-1-4(d), 17 CFR 200.30(a)(61).