

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50441; File No. SR-PCX-2003-71)

September 24, 2004

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment No. 1 Thereto by the Pacific Exchange, Inc. Relating to Trading Securities Valued at Less Than \$1.00 in Subpenny Increments

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, (the “Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 22, 2003 the Pacific Exchange, Inc. (“PCX” or “Exchange”), through its wholly-owned subsidiary PCX Equities, Inc. (“PCXE”), filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On September 15, 2004, the Exchange submitted Amendment No. 1 to the proposal.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons. As discussed below, the Commission is granting accelerated approval of the proposed rule change, as amended, for a pilot period.

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

The Exchange proposes to modify the interpretation to PCXE Rule 7.6(a) to provide for order entry and trading of securities that are priced less than \$1.00 to be entered, executed and reported in subpenny increments.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See letter from Mai S. Shiver, Director, Regulatory Policy, PCX, to Nancy J. Sanow, Assistant Director, Division of Market Regulation (“Division”), Commission, dated September 15, 2004.

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

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

The text of the proposed rule change is set forth in Exhibit A hereto.

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

1. Purpose

As part of its continuing efforts to enhance participation on the Archipelago Exchange ("ArcaEx") facility, the PCX is proposing, on a pilot basis through September 30, 2005, to permit trading of securities that are priced at less than \$1.00 to be traded in increments of \$0.001. Currently, interpretation .05 to PCXE Rule 7.6(a) stipulates that the minimum price variation for quoting and entry of orders traded on ArcaEx is \$0.01. The Exchange proposes modifying this interpretation to allow for order entry in increments of \$0.001 for Nasdaq National Market ("NNM"), Nasdaq Small Cap, and exchange-listed securities that are priced less than \$1.00. In addition, the Exchange acknowledges the Commission's concern that allowing trading in \$0.001 increments in securities priced less than \$1.00 could permit ArcaEx ETP Holders to trade ahead of customers whose limit orders are at the national best bid or offer ("NBBO") in those securities

by improving upon the quoted price in \$0.001 increments.⁴ Accordingly, the Exchange is also proposing to modify PCXE Rule 6.16, which governs trading ahead of customers' limit orders. The Exchange proposes to add a Commentary to PCXE Rule 6.16 to indicate that, during the term of this pilot, for securities priced less than \$1.00, the minimum amount of price improvement necessary to execute an incoming marketable order on a proprietary basis by an 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.

In conjunction with this proposed filing, the Exchange has requested exemptive relief that would permit, on a one-year pilot basis through September 30, 2005, ArcaEx's ETP Holders to provide for order entry and trading of securities traded on ArcaEx (NNM securities, Small Cap Securities, and exchange-listed securities) that are priced less than \$1.00 to be entered, executed and reported in increments of \$0.001, while ArcaEx and vendors that disseminate ArcaEx quotation information report and disseminate quotes for those securities in penny increments.⁵

Further, to advance the Commission's review, and as a condition to the exemption relief

⁴ See PCXE Rule 1.1(n).

⁵ See letter from Mai Shiver, Director, Regulatory Policy, PCX, to Annette L. Nazareth, Director, Division, Commission, dated September 15, 2004, regarding Subpenny Trading Increment for Securities Priced Less Than \$1.00 ("Exemptive Request"). In this letter, the Exchange requested exemptive relief from Rules 11Ac-1, 11Ac1-2 and 11Ac1-4 to allow ArcaEx, its ETP Holders, and vendors that disseminate ArcaEx quotation information to round quotes for securities priced less than \$1.00 to the nearest penny increment (up, for orders to sell, or down, for orders to buy) for display purposes, while such quotes may be entered and executed in increments of \$0.001.

sought, the Exchange has agreed to provide the Commission with monthly reports on its activity in subpenny increments. 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).⁶

The Exchange believes that allowing executions on ArcaEx in securities priced less than \$1.00 would enable investors to sell the security in the event it becomes necessary, *e.g.*, where delisting proceedings have been announced or are imminent. The limited number of price points in low priced stocks necessitates the ability to trade in smaller increments⁷. Also, because the securities subject to this proposal are limited to those that meet ArcaEx's listing standards or are eligible for trading pursuant to the unlisted trading privileges, there are few (less than 1%) that will be impacted by this proposal. Moreover, the Exchange also has the ability to execute in

⁶ The Nasdaq Stock Market, Chicago Stock Exchange, Inc., and National Stock Exchange, Inc., who have all received similar exemptive relief from the Commission, have also agreed to provide the Commission with similar monthly reports on their subpenny trading activity as a condition to receiving such relief.

⁷ See Securities Exchange Act Release No. 49325 (February 26, 2004), 69 F.R. 11125 (March 9, 2004). The Exchange notes that the Regulation NMS proposal's limitation on subpenny trading would exclude securities priced below \$1.00. The Exchange understands that the Commission's proposed Regulation NMS may have an impact on this pilot program. Accordingly, the Exchange has stated that it will undertake to work with the Commission to ensure that the pilot program would be consistent with the rules and regulations that may be adopted by the Commission in connection with its Regulation NMS proposal.

subpennies under certain circumstances⁸ and this proposal, although it relates to all order types, is a limited extension of that same principle restricted to securities priced less than \$1.00.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b)⁹ of the Act, in general, and furthers the objectives of Section 6(b)(5),¹⁰ in particular, because it is designed to promote just and equitable principals of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

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

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

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

⁸ See PCXE Rule 7.6(a), Commentary .07, ArcaEx is able to execute Midpoint Cross Orders and Directed Fills in increments smaller than the minimum price variation i.e., in subpennies.

⁹ 15 U.S.C. 78f(b).

¹⁰ 15 U.S.C. 78f(b)(5).

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>);
or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-PCX-2003-71 on the subject line.

Paper comments:

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

All submissions should refer to File Number SR-PCX-2003-71. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth

Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-PCX-2003-71 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.¹¹ In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5)¹² of the Act, which requires that an exchange's rules be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

Simultaneous with the filing of this proposal, the Commission received a request for exemptive relief submitted by the Exchange that would allow the ArcaEx, ArcaEx ETP holders, and vendors that disseminate ArcaEx quote information to display and disseminate their quotes for securities priced less than \$1.00 in penny increments without a rounding identifier, while

¹¹ In approving this proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

ArcaEx ETP Holders provide for order entry and trading in subpenny increments.¹³ By letter dated September 21, 2004, the Division, pursuant to delegated authority under Rules 11Ac1-1(e),¹⁴ 11Ac1-2(g),¹⁵ and 11Ac1-4(d)¹⁶ under the Act, granted a conditional temporary exemption to ArcaEx, ArcaEx ETP Holders, and vendors that disseminate ArcaEx quote information to permit them to display and disseminate their quotes for securities priced less than \$1.00 in rounded, penny increments without a rounding identifier.¹⁷ The exemption expires September 30, 2005. The Commission notes that the Nasdaq Stock Market, Chicago Stock Exchange, Inc., and National Stock Exchange, Inc. currently trade in subpennies pursuant to similar exemptive and no-action relief from the Commission. Unlike these other exchanges whose subpenny trading is not restricted to a particular price level, the Commission notes that the PCX, by this proposed rule change, is seeking to allow subpenny trading on ArcaEx only in securities priced less than \$1.00, which the Exchange has represented is fewer than one percent

¹² 15 U.S.C. 78f(b)(5).

¹³ See Exemptive Request, *supra* note 5.

¹⁴ 17 CFR 240.11Ac1-1(e).

¹⁵ 17 CFR 240.11Ac1-2(g).

¹⁶ 17 CFR 240.11Ac1-4(d).

¹⁷ See letter from David S. Shillman, Associate Director, Division, Commission, to Mai S. Shiver, Director, Regulatory Policy, PCX (September 24, 2004) (“Exemptive Relief Letter”). The relief granted to PCX is expressly conditioned upon providing the Commission with data specified in the Exemptive Relief Letter. The Commission intends to reconsider the position expressed in its letter before the expiration of the exemption on September 30, 2005.

of all securities traded on ArcaEx. The Commission also notes that, as part of the proposed rule change, the Exchange is amending its rule relating to trading ahead of customer orders to require ArcaEx ETP Holders to improve on their customers' subpenny quotes by a full penny in order to trade of such customer orders. The Commission believes that the proposed rule change should allow for additional liquidity at the less than \$1.00 price level, while providing protection to customer limit orders in the subpenny trading environment by helping to ensure that such orders will continue to have access to market liquidity ahead of ArcaEx ETP Holders' orders in appropriate circumstances.¹⁸

Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2)¹⁹ of the Act, for approving the proposed rule change, as amended, on a pilot basis through September 30, 2005, prior to the thirtieth day after the date of publication of notice thereof in the Federal Register.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁰ that the

¹⁸ The Commission notes that the approval of this proposal in no way prejudices or determines what action the Commission may take with respect to any part of the Regulation NMS proposal.

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ Id.

proposed rule change (SR-PCX-2003-71), as amended, is hereby approved on an accelerated basis until September 30, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²¹

Margaret H. McFarland
Deputy Secretary

²¹ 17 CFR 200.30-3(a)(12).

Proposed new text is italicized.

Rule 7
Equities Trading
Trading Differentials

Trading Ahead of Customer Limit Orders

Rule 6.16 (a) –(d) – No change.

Commentary:

.01 For all securities that are priced less than \$1.00 that are traded pursuant to the pilot program under Commentary .05 of PCXE Rule 7.6(a) with a minimum price variation of \$0.001, the minimum amount of price improvement necessary to execute an incoming marketable order on a proprietary basis by an ETP Holder when holding an unexecuted customer limit order otherwise due an execution pursuant to Rule 6.16(a) in that same security is \$0.01.

Rule 7.6(a) – No change.

Commentary:

.01 - .04 – No change.

.05 The minimum price variation (“MPV”) for quoting and entry of orders in equity securities traded on the Archipelago Exchange is \$0.01, with the exception of securities that are priced less than \$1.00 in which case, on a pilot basis through September 30, 2005, the MPV for order entry will be \$0.001.

.06 - .07 – No change.