

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50538; File No. SR-PCX-2004-89)

October 14, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Exchange, Inc. to Allow Market Maker Quotation Spreads in PCX Plus of up to \$5

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on September 27, 2004, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The PCX is proposing to amend PCX Rule 6.37 to allow quotation spreads for options that trade on the Exchange's electronic trading platform, PCX Plus, to be \$5 regardless of the price of the bid. The text of the proposed rule change appears below. Additions are underlined.

* * *

**Rule 6
Options Trading**

Obligations of Market Makers

RULE 6.37. (a) – No Change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(b) No Change.

(1) Bidding and/or offering so as to create differences of no more than:

(A) .25 between the bid and the offer for each option contract for which the bid is less than \$2,

(B) no more than .40 where the bid is \$2 or more but does not exceed \$5,

(C) no more than .50 where the bid is more than \$5 but does not exceed \$10,

(D) no more than .80 where the bid is more than \$10 but does not exceed \$20, and

(E) no more than \$1 when the last bid is \$20.10 or more, provided that the Exchange may establish differences other than the above for one or more series or classes of options.

(F) The two Trading Officials or the Exchange may, with respect to options trading with a bid price less than \$2, establish bid-ask differentials that are no more than \$0.50 wide (“double-width”) when the primary market for the underlying security: (a) Reports a trade outside of its disseminated quote (including any Liquidity Quote); or (b) disseminates an inverted quote. The imposition of double-width relief must automatically terminate when the condition that necessitated the double-width relief (i.e., condition (a) or (b)) is no longer present. Market makers that have not automated this process may not avail themselves of the relief provided herein (i.e. they may not manually adjust prices.)

(G) Options, designated by the Exchange, that trade on PCX Plus may be quoted electronically with a difference not to exceed \$5 between the bid and offer regardless of the price of the bid. The \$5 quote width shall only apply to classes trading on PCX Plus and only following the opening rotation in each security (i.e., the widths specified in paragraph (b)(1)(A)-(F) above shall apply during opening rotation). Quotes given in open outcry in PCX Plus issues may not be quoted with \$5 widths and instead must comply with the legal width requirements specified in paragraph (b)(1)(A)-(F) above.

(2) – (5) – No Change.

(c) – (h) – No Change.

Commentary .01 - .09 – No Change.³

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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 self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

1. Purpose

The purpose of the proposed rule change is to substantially relax the quotation spread requirements on options designated by the Exchange that trade on the Exchange's electronic trading platform, PCX Plus. Currently, the PCX's rules contain maximum quotation spread requirements that vary from \$.25 to \$1, depending on the price of the option. Each PCX market maker independently is subject to these requirements. According to the PCX, while the primary purpose of the spread requirements is to help maintain narrow spreads, the spread requirements also result in individual market makers sometimes quoting at prices that they believe are unnecessarily narrow, potentially exposing them to greater risk if markets move quickly. The

³ In a telephone call, the PCX agreed to a minor change clarifying that the Exchange is not proposing to amend Commentaries .01 through .09 of PCX Rule 6.37. Telephone conversation between Steven B. Matlin, Senior Attorney, Regulatory Policy, PCX, and Yvonne Fraticelli, Special Counsel, Office of Market Supervision, Division of Market Regulation, Commission, on October 13, 2004.

PCX believes that, due to the market making system in PCX Plus, the quotation spread requirements may not be necessary to ensure tight and competitive quotations on the PCX.

In this regard, the PCX states that the market structure in PCX Plus creates strong incentives for competing market makers and other market participants to disseminate competitive prices. In PCX Plus, each market maker quotes independently and customers and professional traders can enter limit orders on the PCX's book. The PCX automatically collects this trading interest, calculates the PCX best bid and offer ("BBO"), and disseminates the BBO to the investing public. Furthermore, the PCX allocates trading interest on PCX Plus based upon the price and size of the interest. Under the PCX's trading algorithm, the PCX allocates volume to trading interest at the best price. The larger the size of a person's quote or order at the best price, the more trading interest that person receives. The PCX believes that this provides strong incentives for market makers and other market participants to enter quotes and orders that improve the price and depth of the market. The PCX believes that in this model, market forces provide sufficient discipline to maintain narrow and competitive quotation spreads.

Accordingly, the PCX proposes to expand the allowable spreads for options designated by the Exchange that trade on the Exchange's electronic trading platform, PCX Plus. The \$5 quote width shall only apply to options trading on PCX Plus and only following the opening rotation in each security.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act,⁴ in general, and furthers the objectives of Section 6(b)(5) of the Act,⁵ in particular,

⁴ 15 U.S.C. 78f(b).

because it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

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

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

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

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

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

The proposed rule change has been designated by the PCX as a “non-controversial” rule change pursuant to Section 19(b)(3)(A) of the Act⁶ and subparagraph (f)(6) of Rule 19b-4 thereunder.⁷ Consequently, because the foregoing rule change: (1) does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, and the Exchange provided the Commission with written notice of its intent to file the proposed rule change at least five days prior to the filing date, it has

⁵ 15 U.S.C. 78f(b)(5).

⁶ 15 U.S.C. 78s(b)(3)(A).

⁷ 17 CFR 240.19b-4(f)(6).

become effective pursuant to Section 19(b)(3)(A) of the Act⁸ and Rule 19b-4(f)(6) thereunder.⁹ A proposed rule change filed under Rule 19b-4(f)(6) normally does not become operative prior to 30 days after the date of filing. However, Rule 19b-4(f)(6)(iii) permits the Commission to designate a shorter time if such action is consistent with the protection of investors and the public interest. The PCX has requested that the Commission waive the 30-day operative delay specified in Rule 19b-4(f)(6) because the PCX's proposal provides quote width relief similar to that provided under the rules of other exchanges.¹⁰ Accordingly, the PCX believes that its proposal does not raise new regulatory issues, significantly affect the protection of investors or the public interest, or impose any significant burden on competition. In addition, the PCX believes that its request is consistent with the protection of investors and the public interest and that good cause exists, including the PCX's need to maintain competition and efficiency.

The Commission believes that waiving the 30-day operative delay is consistent with the protection of investors and the public interest.¹¹ Specifically, the Commission believes that allowing the PCX to implement \$5 quotation spread parameters like those adopted by the ISE and the CBOE will help the PCX to compete with those exchanges.¹² The Commission believes

⁸ 15 U.S.C. 78s(b)(3)(A).

⁹ 17 CFR 240.19b-4(f)(6).

¹⁰ The proposed rule change is based on International Securities Exchange, Inc. ("ISE") Rule 803(b)(4) and Chicago Board Options Exchange, Inc. ("CBOE") Rule 8.7(b)(iv)(A). See Securities Exchange Act Release Nos. 50015 (July 14, 2004), 69 FR 43872 (July 22, 2004) (order approving File No. SR-ISE-2003-22); and 50079 (July 26, 2004), 29 FR 45858 (July 30, 2004) (order approving File No. SR-CBOE-2004-44).

¹¹ For purposes only of waiving the operative delay for this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹² See note 9, supra.

that the PCX's proposal raises no new issues or regulatory concerns that the Commission did not consider in approving the ISE and CBOE proposals. For these reasons, the Commission designates that the proposal become operative immediately.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate the rule change if it appears to the Commission that the action is necessary or appropriate in the public interest, for the protection of investors, or would otherwise further the purposes of the Act.

IV. 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-2004-89 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-2004-89. 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 this filing also will be available for inspection and copying at the principal office of the PCX. 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-2004-89 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority¹³.

Jill M. Peterson
Assistant Secretary

¹³ 17 CFR 200.30-3(a)(12).